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PUBLIC-PRIVATE PARTNERSHIPS: THE ENABLING ENVIRONMENT FOR DEVELOPMENT

Report prepared by the Secretariat

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INTRODUCTION

1. To many people today, the remedy for bad government is simple: governments should hand over their activities to the private sector, which will do a far more efficient job. Partnerships are not necessary, they say, only hand-over. In this paper we will argue that this is only part of the answer, that governments will have a larger role to play in the future and that they will play that role increasingly in collaboration with the private sector.

2. Public-private partnership implies a common understanding of shared goals, a willingness to repartition responsibilities for their achievement, a continuing public-private dialogue on what needs to be done to promote their realization, and a supportive policy and institutional framework. Partnership goes beyond business concerns, and extends into all policy areas, including education, health, human rights, immigration and citizenship, science and technology, foreign relations, arts and culture. There is a widespread trend to broaden participation in governance by strengthening the interface between the state and non-state actors.

3. This has important political dimensions. In its resolution 50/225 of 19 April 1996, the General Assembly reaffirmed that democracy and transparent and accountable governance are indispensable foundations for the realization of social and people-centred sustainable development. Participation reinforces democracy by making the government more responsive to users of government services and to citizens generally, and making government more open, transparent and accountable. New machinery is set up such as administrative tribunals, ombudsman offices, joint committees, and charters of the rights of citizens (or users, "clients" or "customers" of government services), which tend to make the government agencies which have immediate relationships with the public more accountable and answerable to those affected by their activities. This "direct" accountability complements the indirect accountability of agencies via the political directorate to legislative bodies and heads of State and, in democratic regimes, to electorates.

4. This paper looks at partnership in the pursuit of national economic goals, with a focus on some innovative examples of partnership, and some of the main issues arising. The paper is divided into four main sections, which deal respectively with increasing opportunities in the private sector, the business-enabling environment, promotion of competition and social regulation, and a final section which briefly touches on the role of the international community with regard to the foregoing.

I. INCREASING OPPORTUNITIES IN THE PRIVATE SECTOR

A. Privatization

5. The adoption of large-scale privatization programmes gained considerable momentum worldwide in the wake of the British experiment of the early 1980s. This phenomenon has changed the respective roles of the public and private sector worldwide. Projects and activities in sectors which were formerly

government monopolies, including physical infrastructure and social services, are being increasingly financed and/or managed by private firms under negotiated programmes and contracts. There is a spectrum of disengagement by governments and engagement of private firms in productive activities, including contracting out (also called outsourcing, service contracting or alternative delivery) (see paras. 16-21 below), turnkey construction, management contracts, leasing, concessions/build-operate-transfer, partial disinvestment/joint ventures, and full disinvestment. A particular type of disinvestment which is of central importance in post-conflict countries is the conversion of military installations, personnel and industries to civilian purposes (see paras. 22-28).

6. In terms of the percentage share of GDP produced by private firms, privatization has been most rapid in the countries of eastern and central Europe. The EBRD Transition Report (EBRD 1994) examined privatization in 25 countries of eastern and central Europe and central Asia. In these countries the share of the private sector had risen to about 40 per cent by mid-1994, with the Czech Republic leading the way at 65 per cent, up from 3 per cent in 1986 (see Milanovic: 1989 for other country estimates). The main source of the higher private share in the transitional economies has not been the disinvestment of public enterprises, as might be expected, but rather the faster growth of private enterprises compared with the public sector. Liberalization and the institution of a strong legal base for protecting private ownership have together paved the way for the rapid emergence of private enterprises in these countries.

7. A recent World Bank study (1995) confirms that private sector growth is the major modality of privatization in the developing countries also. Actual disinvestments have been few (less than three per country per year), so the rise in the private share has been due more to the faster growth of the private sector compared with the public sector than to the transfer of enterprises from public ownership to private ownership. This trend may be expected to continue as State-owned enterprises have been taking a smaller share of gross domestic investment.

8. For most developing countries, a clear enunciation of the goals of a privatization and private sector development programme is a necessary prerequisite to any programme implementation. To this end, a matrix of legislative, regulatory and institutional mechanisms directly related to the implementation of the programme needs to be put in place or established at the outset. Training of high-calibre national technical personnel in the oversight and guidance of privatization and private sector development programmes is another significant prerequisite to the implementation and backstopping of the programme. The cadre would be responsible mainly for the preparation of terms of reference for the valuation of enterprises to be privatized, and the selection of qualified personnel to carry out these privatizations and assessing the impacts of the programme, e.g. on employment.

9. Most governments view the provision of basic needs to the lowest income groups as a basic political and economic goal. Because economic re-balancing can worsen income distribution in the short run, the provision of safety nets helps to build public opinion in favour of the programme. The creation of well-targeted safety nets is an integral element in the economic development or

transition of a country. In order for safety nets to be truly effective, they should not be regarded as a substitute for other more significant national policies targeting education, primary health care, and disease control. Rather, safety nets should offer only a temporary and limited relief in a time of structural unemployment.

10. A recurrent problem in privatization by disinvestment is undervaluation. Governments tend to undervalue and sell public enterprises too cheaply and, in some countries, this has been associated with corruption and given privatization a bad name. There are some legitimate reasons for undervaluation, as well as illegitimate reasons, so the problem is to know the difference. In uncertain capital markets, it is usual for the issue price of shares to be set below the expected market value after issue, so as to reduce the risk of failure and avoid the need for underwriting. Many governments have tried to sanitize privatization by broad-basing ownership. This partially corrects for any undervaluation (or overvaluation) and improves the equitable distribution of wealth and subsequent income. On the other hand, it tends to dilute the control of those who have the best ideas about the future directions of the enterprise. This reduces the efficiency dividend. In Sri Lanka, the Government preferred to sell 60 per cent of the equity in each enterprise to a single well-qualified buyer, and broad-base the ownership of only the minority equity, neatly balancing both efficiency and equity objectives.

11. How to reconcile efficiency with equity remains a leading issue in the transitional economies. Equity calls for the distribution of public assets to the people at large, not to those who are able to pay the most for them as a consequence of their (often illegal) amassing of wealth in an earlier regime. This implies free or near-free distribution of shares, as has happened in several voucher schemes. Efficiency, on the other hand, requires that effective control of assets is in the hands of those who have entrepreneurial vision of how they can be most productively used. For this to take place, enterprises must be offered to the highest bidders and potential entrepreneurs must be able to borrow. If vouchers are tradeable and the trading machinery is in place, it can be expected that property rights will eventually gravitate to those who value them most highly. Though this reconcentrates ownership, the equity goal is still served as the initial holders of vouchers sell them at higher prices which final holders are willing to pay. In theory, everyone gains from this process of concentration of property rights. However, the model depends on good company law and capital market regulation: in practice, managers block the emergence of strong external governance. Poland is attempting to establish effective governance over corporate managers through professionally managed national investment funds.

12. Studies of the process of privatization have shown that there are two common reasons for the slower rate of privatization in poorer countries: (a) the relatively higher difficulty of privatization where domestic savings are low; and (b) undeveloped banking, managerial, accounting and legal skills and institutions. This constrains the transitional economies and the least developed countries in proportion to the imbalance of needs and capacity. In effect, the rate of development of this institutional infrastructure determines the optimal rate of privatization (Metcalf and Ambrus-Lakatos 1991). If the rate of privatization is forced beyond the institutional and professional

capacity of a country, it is likely that it will not result in the intended benefits or that it will not be sustainable. The early experiences of Chile and Bangladesh are examples of this. It is now well recognized by the international community that policy reform has to be accompanied by institutional and human resource development, and that this is a medium- to long-term process (see paras. 59-64 below).

13. The pace of privatization in some countries, such as Sri Lanka, has been determined mainly by pressure from international donor agencies (where aid has been conditional on privatization) and from domestic capital market interests. This has had unfortunate negative consequences, such as lower prices from purchasers and little attention paid to transparency. In Sri Lanka this led to allegations of impropriety, public protests and a slow-down in the privatization programme in mid-1992 (Kelegama 1997).

14. Lack of transparency, of course, is more of an issue in trade sales to a single buyer than in stock market issues where elaborate rules of disclosure usually apply. Trade sales have had a political price in Sri Lanka, Mexico and other countries. Governments typically start with a tender procedure which is intended to give all potential purchasers adequate and equal opportunity to make their independent bids, then an award is made to the highest bidder who meets all the prescribed conditions. Even if this works as intended, it is usually only the starting point for protracted negotiations leading to a final settlement and transfer of the enterprise. This is the point where transparency may be lost, as the conditions attached after the bids are invited may entirely negate their ranking. There are many cases of governments modifying the conditions laid down at the point of tender, or giving undertakings as to protection of the company's domestic market, guaranteed sales, or other policy sweeteners. The fact that these negotiations are always carried out behind closed doors does not create public confidence that the best possible deal has been made.

15. A campaign to inform and educate the public on the privatization programme is an important component in its overall success, but not a sufficient condition for public acceptance. Transparency relates to the terms of individual transactions. A simple requirement that the final contract be published, omitting any commercially sensitive data, together with all bids and the criteria of evaluation (as is done in Ghana, for instance), has important advantages: first, it would protect the negotiators from charges of impropriety (or alternatively, provide a clear basis for their accountability); second, it would avoid unnecessary suspicions, charges, investigations and delays.

B. Contracting out

16. Just as governments are facing up to the challenge of hiving off their public enterprises to private ownership and/or management, at the same time they are examining their own expenditures, at central and local levels, with a view to identifying activities that could be contracted out to private firms at lower cost to the public purse and higher quality to users. "Alternative delivery" of public services opens up options which many governments are exploring. Services to the government such as office cleaning, canteen services, buildings and

grounds maintenance, printing and legal services and the contract leasing of vehicles are common examples. Services by government agencies which are widely contracted out include the collection and disposal of solid waste, street cleaning and lighting, road maintenance and almost all infrastructure construction. Less frequently contracted are the "preventive" services, such as prison detention and corrective services (which are contracted out in Australia, the United Kingdom and some states of the United States of America), environmental monitoring (e.g. water standards in Chile) and tax collection (Chad, Indonesia). Some hard-pressed governments have contracted out even defence to mercenary forces, though most democracies would prefer not to have their national security left to private armies.

17. If the public goal is simply economic, that is, to provide quality public services at the lowest possible cost, the decision to contract out a service depends on the supplier's price, plus contract administration costs, being less than the total costs of in-house production as before. This simple calculus implies that contracting out should be decided on a case-by-case basis, even if there is a general policy in favour. The rule is often forgotten, particularly the need to include contract administration costs in the equation. Even in the industrialized countries, few government agencies have any idea of what they are spending on contract letting, administration and monitoring, though one survey found that these costs added up to an average of 16 per cent of contract cost, with wide variation from one service to another (Stevens 1984). A more sophisticated analysis would also take into account the disposal of assets that may no longer be needed and the costs of personnel resettlement (Prager 1992). For many governments, the personnel implications are all-important, since long-term contracting out implies a movement of personnel out of the government service to independent contractor or contractor employee status. Governments may make it a condition of contracting out that the contractor absorbs both the fixed assets and employees formerly in government service. There may be retraining costs, terminal payments and compensation for loss of job security.

18. In countries which have made the greatest use of contracting out, such as the United States of America and the United Kingdom, the studies are almost unanimous in their finding that costs are saved without loss of quality, and even with gain in quality. Cost savings are typically in the range of 20 to 30 per cent of the former cost of government provision (Savas 1992), despite the requirement (in the United States) that contractors pay their workers no less than prevailing wages. Developing countries and countries in transition, however, should not expect the same magnitude of savings unless there is keen competition among potential suppliers. The less the competition, the less the potential savings by a change to competitive bidding. Gains could be in quality rather than cost: in Jamaica, the contracting out of hospital dietary services actually led to an increase of government expenditure as standards were raised substantially.

19. One alternative delivery option is to improve the existing service and to "contract in". In-house providers should always be given the opportunity of reviewing and re-engineering their own operation so as to make themselves more efficient, if necessary by separating themselves from administrative red tape in order to be more flexible, as in the "executive agencies" of the United Kingdom, Australia, New Zealand and Singapore. The prospect of losing work to an outside

agency brings out innovative thinking and willingness to reform obsolete work practices. In practice, competitively bid contracts are often won by the in-house provider. In the United States, federal government agencies win contracting-out competitions 40 per cent of the time (report of the President's Commission on Privatization, 1988). In the United Kingdom, where local authorities are required by law to put services to competitive tendering, in-house providers are now getting the majority of total contracts.[1] The efficiency and savings come, not from privatization per se, but from the introduction of competition. Savings are sustainable for as long as competition is maintained.

20. A major advantage accruing from the preparatory work for contracting is that government agencies are forced, often for the first time, to define and specify, in a monitorable form, exactly what services they are providing, to whom and to what standards. Thus, even if the service is not ultimately contracted out, valuable data is provided for better planning and supervision.

21. There are five main constraints on the development of government contracting which are commonly experienced in developing countries:

(a) Political leadership to envision such public-private collaboration and to push for its realization, often against political and labour opposition and vested interests in the civil service;

(b) Lack of sufficient firms to establish competitive bidding. This may be due to a government-imposed monopoly, which can be removed by deregulation, or it may be a simple consequence of a past tradition of government provision, such that no entrepreneur has tried to bid. The first step is an analysis of capacity of potential suppliers. Where there is insufficient competition, the government may divide the work (e.g. geographically) between outside contractors and inside workforces, as is done for instance by the city of Bogota, Colombia, where solid waste collection is shared between public and private agencies, with a private firm made responsible for monitoring the operations of all the agencies.[2] Continued government provision of at least part of the service provides in-house knowledge of costs and technology changes and thereby some protection against inflated contracts;

(c) Scarce administrative capacity to draw up, negotiate and monitor contracts in an impartial and non-corrupt manner, to structure partnerships and to ensure that they operate in the public interest, while maintaining independence and avoiding conflicts of interest or regulatory capture;

(d) An organizational implication of contracting is the need to make the contract unit independent of the operations unit (the Chinese wall problem); if these are branches of the same ministry or involve former colleagues, they may act in collusion. Even without collusion, it is necessary to ensure that in-house units do not underbid to get contracts, secure in the knowledge that a loss on the contract will be met by the government;

(e) Lack of accounting data or unreliable data to make good decisions, e.g. on the economics of contracting out. As government accounting is almost

everywhere on a cash basis, not a full-cost accrual basis, the cost of in-house operations is likely to be understated.

C. Military conversion

22. Military conversion can be divided into five areas, namely: (a) military industry; (b) military sites; (c) research and development; (d) demobilization; and (e) surplus weapons. They offer different challenges and opportunities and vary in their application to the industrialized countries, the economies in transition, and the developing countries. Like technological adaptation in the civilian sector, conversions provide tremendous opportunities for private sector development. In fact, conversion may be part of the broader transformation of societies, as in the case of Angola, Bosnia and Herzegovina, Cambodia, Egypt, Ethiopia, Guatemala, Panama, South Africa, Viet Nam and Zaire. Thus, the process of military-to-civilian structural adjustment is complex and dynamic.

23. As with all privatization, conversion initiatives can only be sustainable in favourable political, legal, economic and social frameworks. In many instances, there is a geographical concentration of military sites and industries. This aggravates the impacts of conversion on the stakeholders in such sites and industries, particularly the local stakeholders and their families, namely the men and women in uniform, the workers, managers, local private enterprise suppliers, local governments, etc. Sustainable conversion can only benefit from the active engagement of the local stakeholders in setting up priorities for future public-private initiatives in manufacturing, services, research, education, training, etc. as illustrated by the cases of Subic Bay in the Philippines, and sites in Europe and the United States, where all stakeholders, at different levels, have been organized to join partnerships in order to respond to the problems of the redevelopment of the closed bases and restructuring of defence industries. Generally speaking, conversion processes stand a better chance of success when they are integrated into the development of a country or region.

24. Since the ultimate resource in conversion is human capital, the engagement of workers and managers of military sites and industries in conversion planning and implementation can be more important than the reallocation of physical assets. Usually, the military industries and sites attract some of the best technical talents in a country. This human capital is an important component in viable conversion to knowledge-based sustainable activity, and constitutes a pool from which private sector managers and entrepreneurs can evolve.

25. The setting up of public-private partnerships can be facilitated by promoting stakeholders' dialogue and consensus, as this empowers the constituencies closest to the issues of conversion and helps build up solidarity among them. Conversion can be greatly stimulated by the expansion of existing networks to the developing countries and the economies in transition, thus truly globalizing them. Dialogue also contributes to curbing corruption and other illicit practices by the exposure and sharing of information, keeping the process transparent to all concerned, and promotes market forces as it spreads information throughout the immediate markets affected. Dialogue would also help

improve coordination at all levels of government for mutually reinforcing actions.

26. In the former centrally planned economies there is a natural reluctance to create redundancies, particularly in areas of large concentration of military sites and industries which have few immediate employment alternatives. For these countries, and in developing nations also, social safety nets have been designed for displaced workers, together with training programmes to develop new skills required by private firms in new markets. The set of skills required of a converted enterprise - site or industry - is often radically different from that necessary to the original company. Thus, conversion needs a radical change in attitudes of the workers and managers involved. Countries such as the Russian Federation, China, Belarus, Ukraine, Poland, Cambodia, Viet Nam, Argentina and Egypt in the last several years have either initiated various training programmes or established institutions as clearing houses, training centres and business promotion intermediaries.

27. As the political, economic and military reorganization of the world takes shape, the resources spared by the overall decline in military budgets - the peace dividend - could, in principle, help finance sustainable development initiatives. But there is so much competition for these same resources that the peace dividend cannot be taken for granted. Thus, the implementation of initiatives for military conversion must find resources from a diversified portfolio of sources, some conventional, others non-conventional, as exemplified by debt swaps, buy-operate-transfer (BOT) finance, offsetting of government civilian procurement, etc. One such source, often overlooked, is the hidden resources represented by waste in existing military activities, which could lower the capital requirements for new, converted sites and industries. In St. Louis, Missouri, United States, several projects have been launched to identify the hidden resources - equipment, technology and skills - to be used for community development and new business start-ups.

28. Public-private partnerships, whether entirely domestic or involving foreign partners, are worth promoting as a means of realizing and expediting conversion. Small and medium-sized enterprises which have a high collective employment potential could especially be promoted, such as service businesses, originating from military research and development, manufacturing or military sites, which require much less capital per worker, e.g. health services, warehousing, port and airport services, maintenance and repair services, tourism, education, training, consulting, information services.

II. BUSINESS ENABLEMENT

A. Public-private dialogue

29. Where government is the dominant institution in a country, only the government can lead in envisioning and planning the policies and support institutions and infrastructure - physical and human - for businesses to thrive in an enabling environment conducive to private sector investment and growth. Support institutions may include specialized agencies in fields such as finance, research and development, acquisition of technology, export promotion, market

intelligence and human resource development, which may need government sponsorship pending the development of markets for their services.

30. Many areas of policy impact on business. Particularly important are policies on trade and liberalization, deregulation, privatization, competition, education and training, labour, investment, taxation and the environment. Unilateral decision-making by governments in these fields is a blunt instrument. Greater realism, precision and effectiveness is possible by drawing on the experience of the private sector. The business consequences of draft policies and programmes need to be explored with relevant private sector representatives. Regulatory reform, for instance, requires a partnership between government and the private sector, so that essential social objectives are met without killing the goose that lays the golden eggs (paras. 51-64 below). OECD notes a strong trend towards renewal and expansion of public consultation in regulatory development. A well-designed consultation programme can contribute to higher quality regulations, identify more effective alternatives, lower costs to business, achieve better compliance and faster regulatory responses to changing conditions (OECD 1995). On the other hand, it slows down administration and may weaken the authority of decisions (Braibant 1996).

31. In some countries the government has interacted closely with the private sector and promoted a sense of partnership in the pursuit of national goals. This has applied particularly to partnership with the business community in order to promote export-led economic growth. Partnership is promoted (a) by setting up a structure of interactive interventions - business councils, consultative committees, ad hoc committees, advisory commissions, etc. and (b) by reorienting civil servants away from dysfunctional attitudes to business (characterized by arrogance, distrust, envy) and in favour of pragmatic problem-solving towards shared goals. Stereotypes and misconceptions of business ("we work to serve the public: they work for profit") have been replaced by positive attitudes, such as Prime Minister Mahathir expressed to Malaysian civil servants: "Why shouldn't civil servants help the private sector make money? Who really pays the salaries of the civil servants ... if not the business people?"[3] At the same time, the business clamour for subsidies and tax breaks has been replaced by attitudes of self-reliance. These changes were achieved in Malaysia by sustained strong political leadership, massive training, and an administrative reform programme which proceeded in parallel.

32. The specific aims of the Malaysian, Singaporean and other governments have been to get private sector understanding and feedback on the operation of policies, rules, regulations and procedures which affect their economic performance, and suggestions for changes which are in the general interest. The main areas of interest have been business licensing, taxation, import and export procedures, physical infrastructure - all the areas which make up the enabling environment for business, which in practice are often more disabling than enabling.

33. In Malaysia, public-private interaction, in a formal sense, dates back at least to the establishment of the Industrial Advisory Council of 1979 but took off in 1983 under the banner of "Malaysia Incorporated". The country's impressive growth since then has been widely attributed to this policy. The benefits have been: (a) wider understanding of government strategies, policies

and procedures, (b) private sector "voice" in the determination of strategies, policies and procedures, which in turn has promoted democratic consent, transparency in the decisions and actions of government, and market efficiency (through lower transaction costs), and (c) an appropriate balance between stability and change in government policies.

34. The process depends, as in any partnership, on the prospect of gain by all participants. Though there is frequently great stress on common goals and values, in fact business and government representatives may have differing goals and values, particularly on regulatory issues, and different perceptions of how they are to be achieved, and yet reach mutually beneficial agreements. Where panels or committees do not have agendas of interest to all participants, or where little useful change can be expected, attendance drops away. The majority of ad hoc forums in Malaysia have not continued after a couple of meetings (Chang 1996).

35. The machinery in Malaysia is extensive. There are consultative panels in most ministries and departments at Federal, State and district level. Lower level structures parallel the Federal structure, which was the first to be developed. Mostly they are created by administrative direction on the initiative of the Government, though some, such as the Industrial Advisory Council, were created by statute, and some (mainly informal) meetings are called by the private sector. Their origins and constitutions do not matter so much as their membership and agenda.

36. On the government side, the highest council, the Business Council, is led by the Prime Minister, the annual budget dialogue is led by the Minister of Finance and annual dialogues with industry by the Minister for Trade and Industry. The private sector is represented by employer associations for each of the main ethnic groups, and State-owned enterprises, while foreign investors are represented by transnational corporations. In some important fora, such as the Business Council, the media and academic institutions are also represented. Until recently, labour was not represented. This reflected the earlier lack of confidence, as in other East Asian countries, in the ability of labour unions to take a national view of issues. Labour has now been included in the partnership because its leaders have subscribed to the national leadership and ideology, and also because their participation has become more crucial in conditions of labour shortage (Chang 1996).

37. One issue is the limit to cooperation. Where the government performs a balancing role, looking after the interests of other groups (such as customers in the area of utility tariff regulation) as well as business, the relationship should be at arm's length rather than cosily cooperative. The reverse side of the partnership coin is the risk that civil servants and big business collude in their own interest at the expense of the general public, or at the expense of groups such as small and medium-sized enterprises which are left out of the mainstream of collaboration (see paras. 40-50 below). The risks of corruption, mutual favours, and "regulatory capture" are higher where the two sides come from the same socio-ethnic groups, and where social interactions such as social and sports meetings are promoted as well as strictly business interactions. Connections with the right people may be used to secure contracts, licences, import permits, etc. It should also be remembered that many of the regulatory

personnel and many of the managers of the privatized State-owned enterprises were former colleagues in the same departments. This danger is recognized in Malaysia where General Orders and two circulars in 1993 have prescribed the acceptable standards of behaviour by public officials.

38. An issue which is not widely recognized is the potential conflict between government support to industry, and in particular to exporters, and the rules of the World Trade Organization. The Agreement on Subsidies and Countervailing Measures (ASCM) defines the concept of "subsidy" and establishes disciplines on the provision of subsidies. A subsidy involves a financial contribution by a government or public body, which confers a benefit. Almost all goods or services provided by a government other than general infrastructure would appear to be subsidies as defined by the ASCM. This contrasts markedly with the common practice, by all governments, of subsidizing exporters by means of tax incentives, government funding of research and development, tied official aid, export credit guarantees, commercial intelligence activities through foreign diplomatic representation, and high-profile trade missions (Economist, 1 February 1997).

39. The constraints to the development of partnerships are mainly attitudinal and organizational. The prevailing culture of government may include risk avoidance, secrecy, and suspicion (even antipathy) for the private sector. Reorientation training can displace the established culture and bridge the gap between public and private, but widespread change is a long-term process, particularly in former centrally planned command economies in which entrepreneurial activity has only recently been decriminalized. Productive interaction with the private sector may be used to reinforce responsiveness, transparency, impartiality, objectivity and accountability as major professional values of the civil service.

B. Promotion of entrepreneurship and small enterprises

40. There are a number of unique features in small enterprises, including in this term micro-, small and medium-size enterprises (SEs), that can help to explain their key role in a nation's economic success. Although entrepreneurship is important for all types of enterprises, it is especially important for SEs, which typically constitute the bulk of total enterprises by number. In many countries enterprises in these categories account for more than half of industrial employment and as much as a third of the national product and export earnings. They tend to be highly innovative, make excellent use of scarce capital and skills, and provide a range of services and goods to the large corporations. In countries in which economic units are often too large to be economically efficient, many new small units are needed because they are responsible for a great deal of technological progress. The lack of small-scale entrepreneurs, especially the "missing middle" (small and medium-sized entrepreneurs in the modern sector), is a handicap to economic progress.

41. However, SEs face many constraints. Generally, they lack access to capital, appropriate technology and information about national and international markets. In some countries, particularly the former centrally planned

economies, government policies and business attitudes do not favour SEs, and even create barriers to their operations.

42. The task of promoting small enterprise development involves essentially two main strategies: they can be loosely characterized as a top-down/indirect approach and a bottom-up/direct approach. The top-down approach seeks to create an enabling or "fostering" environment, which provides the right incentives for small firms, together with enough positive support and protection (e.g. against unfair practices of larger competitors) to allow such firms to make the best of their potential.[4] The top-down approach seeks to improve the business environment by operating on macroeconomic variables such as prices, government regulations and policies, by providing legislation and enforcement, and by building up the physical infrastructure. The second strategy, the bottom-up approach, aims at supporting small enterprises directly by mobilizing indigenous resources, creating or reinforcing local institutions and support systems, and with the active participation of beneficiaries. Central and local governments, decentralized government bodies, financial institutions, business and industry associations, chambers of commerce, universities, international organizations and donor agencies have worked, independently and together, in both the creation of an enabling environment and the provision of direct support to small enterprises.

43. In the past, most small enterprise policy has focused consciously on fostering timely access to the factors of production and to markets, with the involvement of state development banks, public sector technical assistance, etc. Rather than complementing and cooperating with private entities in, say, the financial and technical assistance areas, governments have substituted for what was felt to be the inadequate performance of the latter. Part of the challenge at present is to find ways which make private markets work better rather than replacing them. One view gaining widespread acceptance is that governments should concentrate on creating the enabling environment, including macroeconomic policy-making, legislation and enforcement, catalytic promotion and regulation and that direct support to the sector should be provided by private individuals, firms and non-government organizations.

44. There are a number of situations in which partnership between public and private sector institutions is the most efficient and effective mechanism, due to the presence of mutually reinforcing goals - which in the final analysis converge towards an equitable and sustainable economic development of the country - and to the complementarity of capacities and roles. Through partnership, governments and private entities assume co-responsibility and co-ownership for the promotion of small enterprises. Through these novel modalities, the advantages of the private sector - dynamism, access to finance, knowledge of technologies, managerial efficiency, entrepreneurial spirit - are combined with the social responsibility, network of contacts, environmental awareness, local knowledge, and job generation concerns of the public sector. For example:

(a) The government farms out the functions which need to be performed for SE promotion, such as organization of support/regulation systems, to private entities, seeking when possible the joint financing of such initiatives;

(b) The government allocates a specified share of government procurement to SEs;

(c) Public-private partnerships are established for the creation of institutions such as business support centres, business incubators, industrial parks, or centres to disseminate technical and commercial information for small enterprises. These institutions are usually, and optimally, financed and/or operated by both public and private sector entities, such as universities, public development corporations, development banks, industry and entrepreneur associations, venture capital firms, etc.;

(d) More cooperation of local authorities (and less involvement of national governments) with local NGOs, industry and entrepreneur associations and universities. For example, the impressive performance of Italian small enterprise (e.g. in international markets) is due to the effective interface between municipal government (with a long and special involvement in the local economy) and small business;

(e) The establishment of institutional mechanisms for dialogue between the government and interest groups representing small enterprises, viz. industry associations, entrepreneur associations, chambers of commerce, cooperatives (as described in paras. 29-39 above). The development of effective means of consultation with the private sector is essential even for decisions which must remain in the public sector. The importance of involvement by business associations lies in their direct knowledge of the needs of their affiliates and the mobilization of collective action on other fronts.

45. Some of the policy areas relevant for the success of SEs where public-private cooperation appears to be the most suitable mechanism for support include: entrepreneurship, managerial assistance, access to financing and to technology. It is generally accepted that technology provides growth in output and tangible improvements in efficiency and productivity. For this reason, access to appropriate technology, together with an effective technical and managerial assistance programme, is vital for the development of small enterprises. But, as with financial resources, it has proven difficult to develop such programmes. When they are lodged in the public sector they must often overcome weak staffing and lack of incentives to have a good chance of success. When they are lodged in the private sector they are typically too expensive to be of much relevance to small enterprises. The inability of SEs themselves to access adequate technological and managerial resources, together with the modest efforts of governments, indicate the need for a synergistic partnership.

46. The United Nations EMPRETEC programme, now operating successfully in 10 countries in Latin America and Africa, promotes entrepreneurship on two levels - the national policy level by creation of legal and institutional infrastructures conducive to SE development, and by capacity-building of both national institutions and individual entrepreneurs. By working closely with governments, business organizations and SEs themselves, EMPRETEC influences national policies in the areas of taxation, insurance and labour law, and is midwife to the creation of business support centres, entrepreneurs' associations, cooperatives and international networks. Typically, the EMPRETEC business support centres

established in each country are active coalitions of public institutions, private business associations, national and foreign companies, and multilateral organizations, led by National Executive Committees comprising high-level public officials, entrepreneurs' representatives and prominent business leaders from local and multinational companies operating in the country. These have proven essential in setting the institutional base of the programme and in securing its capacity for self-financing after initial donor funding.

47. For an optimal environment, entrepreneurs and SEs need to be recognized and valued by policy makers and society. In many transition economies, SEs have only recently emerged from the black market and gained legitimacy. New entrepreneurial ventures in particular require confidence-building measures from governments and society. One of the first adjustments that governments and societies must make is to overcome a cultural constraint and accept the idea that profit-seeking is healthy, that entrepreneurship and free enterprise can be in the best interests of the greatest number of people. For effective public-private partnership in economies in transition, the greatest need is for an entrepreneurship-friendly environment, including institutional, legal and cultural infrastructures. This will ensure a political and economic system where business risks will be rewarded and returns protected, contracts can be enforced and the social order upheld. Mechanisms of public-private cooperation in fostering the entrepreneurial culture include the introduction of entrepreneurship education and training at public schools and management institutions, where the training is carried out by private sector institutions. Other mechanisms include joint advertising campaigns, establishment of public honours and recognition of merit of successful entrepreneurs.

48. Lack of financial accommodation is reported as the principal problem of small entrepreneurs. One of the reasons for the limited access of SEs to capital from the formal financial sector is the higher administrative cost and higher default risk as perceived by the financial institutions. Such cost differentials go a long way towards explaining why credit goes disproportionately to the large-scale sector. Lack of collateral and security and an undefined legal framework contribute to this bias. Commercial financial institutions cannot easily provide a large flow of credit in small loans to firms with no track record, no guarantee and no security. Another important reason, however, is that some private and public banks have special relationships with their large clients; they may, for example, be part of the same conglomerate. Thus, favouritism towards the "related" companies is natural and inevitable in these cases, but at the same time its presence calls for a corrective action to "level the playing field" among potential borrowers. It is in this direction that public-private cooperation and other innovative and alternative financial support projects are moving. Public-private cooperation directed at the financial support of small enterprises provides a "carrot" to encourage existing financial institutions to be more sensitive and responsive to the financial requirements of SEs.

49. References to innovative financial programmes usually include new institutional arrangements such as the Grameen Bank and its counterparts in other countries, rotating savings and loan associations, microlending and venture capital. The main purpose of establishing these programmes is to create favourable conditions for SE entrepreneurs to obtain financial resources on

reasonable terms. In this area, public-private interaction shows particular promise, as shown by the Bolivian Banco Solidario ("BancoSol"). Founded in 1992 as a microbank, today it is a fully fledged bank offering a wide range of savings schemes, with particular attention to small enterprises. With over 70,000 clients and a portfolio of US $40 million, it now serves one third of the country's banking customers.

50. An initial public subsidy permits a microbank to be set up to lend small amounts of money, with or without collateral, to pioneering and potential entrepreneurs. Once the initial financial resources are provided, the microbank can gain credibility as a sustainable and profit-oriented financial institution, and can attract deposits and borrow from commercial banks. It seems that some public subsidy to the fledgling financial institution is necessary for it to evolve to a self-sustainable commercial activity. The result is a "virtuous circle" in which public money catalyses private dollars. The experience of the BancoSol in Bolivia has demonstrated the potential roles of the government and private sector in building a specialized financial institution for small businesses. At the same time, this experience has confirmed the widespread idea that excessive subsidization of SEs would prove counterproductive in the long term, and that to have a concrete effect on the national economy, the financial institutions which supply credit and other financial services to small enterprises must first cover their costs and be profit-oriented themselves.

III. PROMOTION OF COMPETITION AND OTHER SOCIAL REGULATION

51. The more that is privatized and outsourced, the more crucial is the supervisory role of government in ensuring that the enlarged private sector, in following its private interests, is also meeting the requirements of society as a whole. A market economy requires clear and stable laws and regulations which are no more intrusive than necessary. The reform of the framework involves deregulation to free up activity and allow the emergence of self-regulating capacity in markets and civil society.

52. Regulation by government intervention in the free working of business and markets is traditionally justified by various well-known forms of market failure. There is a growing appreciation that market failure is not a sufficient justification, since intervention has an administrative cost. Also it may be misguided and result in stifling the emergence of competition. In fact, it is extremely difficult to establish a regulatory regime which is both expert and independent of capture by well-endowed enterprises (who may be supported by strong ministers), nor perverted by short-term political interests.

53. In the 1970s and 1980s there was great interest in regulation because of public discontent with the price, quality and cost performance of regulated firms. In the 1990s, strong trends to liberalization and demonopolization have ended the need for administrative regulation in some markets, because competitors (or potential competitors in a "contestable" market) do a much better job than governments of restraining unwarranted price increases and improving quality and variety. In competitive markets, the customer is king. Some traditional "natural" monopolies, such as telecommunications, are also becoming competitive, even with regard to basic line networks, by the

development of new technologies, such as wireless telephony and optic-fibre cable. Other natural monopolies can be subjected to competition by periodically auctioning each franchise to the highest bidder or, in a consumer-friendly variant, to the bidder who offers to supply at the lowest price.

54. However, the need for administrative regulation continues in markets dominated by monopolistic or oligopolistic suppliers. Regulation is moving up the political reform agenda because of privatization. Unfortunately, regulation is not popular in a time of privatization by disinvestment. When a government is trying to entice the private sector into bidding for public enterprises, it tends to postpone anything, such as regulation, which may dilute private interest. State enterprises, which normally carry with them monopoly powers inherited from an import-substitution and economies-of-scale era, will attract more bidders and fetch a better price if the new owners are allowed to continue their monopolies. Governments are often driven more by short-term fiscal considerations than efficiency arguments, so they avoid tackling this issue, promising themselves that they will return to it later, when everything is safely sold. By then, of course, enterprises are in a position to lobby for the maintenance of the protection and privileges which they paid for in the price. Where shareholdings are broadly based, it is politically difficult to reduce the dividend expectations of large numbers of voters.

55. On the other hand, there are two strong arguments in favour of regulation: (a) investors will prefer the security of pricing rules which are fixed and out of reach of arbitrary political interference; and (b) governments are worried about the distributional effects of monopolies, more so than their efficiency effects. Higher prices to poor electors are politically more damaging than the less visible effects of low efficiency. It is generally recommended that, since privatization is intended, inter alia, to increase efficiency and since it is important to keep prices of essential items to a minimum, competition must be promoted and, until it exists, it must be simulated by a system of regulation (Jones 1993). The general maxim is: competition where possible, regulation where necessary.

56. The current issues are concerned with choices between a cost-plus regime (typified by many United States utilities) or a price cap (typified by the RPI-X formula started in the United Kingdom); between a single regulator, a regulatory board, or sectoral regulatory agencies; whether to break up a national monopoly into regional monopolies; the rate at which competitors should be licensed, bearing in mind the need for the incumbent enterprise to finance major expansion as far as possible from internally generated surpluses; etc.

57. The choice between a cost-plus pricing formula and a price cap is usually represented as though cost means actual historic cost (in which case managers have no incentive to reduce costs), while a fixed price motivates managers to reduce costs (since this maximizes profit). In fact, the contrast is not so clear cut. If cost means future estimated or target cost (as in United States utilities) and if successive period price caps can be adjusted based on past profits (as in the United Kingdom), there is no difference in the incentive effects of the two bases. Cost-cutting incentives arise only by virtue of the period of time for which managers can operate before the next review (the longer the period, the stronger the incentive to cut costs).

58. The institutional form of monopoly regulation is a current issue in many developing and transitional countries. The United Kingdom and Argentina created a regulatory agency for each industry, but the recent trend is towards multi-sectoral agencies, as in Jamaica and Malaysia, which can pool cross-sectoral skills such as financial analysts, economists and lawyers. These also have advantages in standardizing regulatory systems, valuation methods, etc. and reducing cross-sectoral inconsistencies and inequities, as well as minimizing the transaction costs and delays inherent in setting up multiple institutions. Regulatory boards are more often preferred to single regulators in order to reduce the burden of individual accountability and opportunities for corrupt practices. In many countries, the corruption issue is very serious and regulatory regimes must be designed to keep regulatory discretion to a minimum, e.g. by relying more on potential competition, by making regulations very simple and automatic, and making regulatory decisions transparent (reasons to be given) and justiciable. Autonomous anti-corruption agencies, such as in Botswana, Sri Lanka and Singapore, can contribute to clean regulation.

IV. ROLE OF THE INTERNATIONAL COMMUNITY

59. In the third world, the government is the dominant institution in society. The problems of privatization and the enablement of business are all government problems. These new tasks are more difficult and complex than governments had before. New organizational structures have to be built, new skills imparted to carry out new functions, and new attitudes developed to displace a culture of risk avoidance and secrecy. Governments need to be able to analyse market conditions; set policy frameworks; draw up, negotiate and enforce contracts; regulate monopolies; coordinate, finance and support producers; enable community self-provision; and provide consumers with information on their options and remedies.

60. This is the challenge to governments. The challenge to the international community is to support them in these changes. At the World Economic Forum in Davos, Switzerland, last February, the Secretary-General said: "there is a new universal understanding that market forces are essential for sustainable development. Second, the role of the State is changing in most of the developing world, from one that seeks to dominate economic life, to one which creates the conditions through which sustainable development is possible." He called for a new partnership among governments, the private sector and the international community.

61. The dramatic increase in world trade, the emergence of powerful new trading blocs and the lack of direct foreign investment in the least developed countries (only 1 per cent of the total goes to 48 least developed countries) have contributed to the marginalization of the world's poorest nations. By contrast, United Nations assistance goes predominantly to low-income countries, where it should focus closely on establishing the conditions for private sector development.

62. This is in line with United Nations policy decisions. The General Assembly has said that United Nations activities, inter alia, should focus on the promotion of private sector involvement in development through public-private

partnerships and other interactions. It was specifically recommended that the sectoral and cross-sectoral agencies of the United Nations provide, on request from governments, independent evaluations and assessments of their privatization policies and programmes; that the United Nations should expand its assistance to the Member States concerned with military conversion; manage an information clearing house; develop enterprise conversion models; and provide technical support (General Assembly resolution 50/225 of 19 April 1996). Assembly resolution 50/106 of 20 December 1995 on business and development mandates United Nations agencies to foster active participation in support of entrepreneurship, privatization, demonopolization, the simplification of administrative procedures, and the encouragement of private-sector involvement in the efficient construction and maintenance of infrastructure. With respect to entrepreneurship, resolution 50/106 particularly valued the promotion of small and medium-sized enterprises. As a follow-up to this, the Economic and Social Council adopted resolution 1996/51 on action to be taken against bribery and corruption in international commercial transactions.

63. The twelfth Meeting of Experts on Public Administration and Finance (see A/50/525-E/1995/122) recommended that the United Nations Programme help governments define the role and scope of the public, mixed and private sectors and to suggest options in the modalities of interaction in accordance with the practical realities in each country, especially at the local and municipal levels, by means of specific technical assistance, dissemination and exchange of country experience and research on the conditions for successful replication. The United Nations can orchestrate governments and international agencies in addressing social needs through public-private interactions, and act as a facilitator in the sensitization to needs and in stimulating the flow of resources. Special attention should be given to the development of new services, e.g. in recreation, health and environmental protection, and to the development of reliable cost data.

64. In the area of infrastructure, the World Bank Group (the World Bank, IFC and MIGA) is active, not so much as a provider of capital as in the 1980s, but as a catalyst for private capital, and by encouraging governments to adopt business-friendly policies and systems and to develop local capital markets which will reduce dependence on foreign capital by mobilizing domestic savings and repatriating flight capital. The World Bank helps countries get access to limited recourse project financing by providing guarantees of syndicated bank loans and bond issues. As policy and institutional reforms take hold, the need for such support diminishes and is taken over by commercial institutions (Ferreira and Khatami, p. 27).

Notes

[1] In the period April 1996-January 1997, in-house providers got 148 awards totalling about £533 million, while private firms won 142 awards totalling about £270 million. Public Enterprise, February 1997, Emap Business Communications: London. To prevent underpricing by in-house providers, there are sanctions on local authorities which lose money on such contracts.

[2] Sandra Cointreau-Levine, Private Sector Participation in Municipal Solid Waste Services in Developing Countries, vol. 1, The Formal Sector, Washington, D.C.: World Bank 1994, pp. 22 and 26.

[3] News Straits Times, 30 July 1996.

[4] Berry, 1995, p. 1.

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ENABLING PRIVATE SECTOR DEVELOPMENT: CHARACTERISTICS OF THE IDEAL POLICY ENVIRONMENT

Report prepared by the Secretariat*

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PREFACE

Setting the scene

United Nations embraces free markets

"There is a new universal understanding that market forces are essential for sustainable development. The role of the State is changing in most of the developing world, from one that seeks to dominate economic life, to one which creates the conditions through which sustainable development is possible. ... The United Nations has a vital role to play in supporting and preparing the ground for domestic and foreign private investment."

Secretary-General of the United Nations
World Economic Forum, 1 February 1997

What happens if a Government gets it wrong?

"Sound policies are absolutely essential. One of the most foolish things said about the international economy these days is that because capital moves so quickly and so freely, government policies have little influence. In reality, precisely because of greatly increased capital mobility, the difference between having the right and wrong government policies has never been greater. ... And just as good policies are rewarded more richly than before, mistaken policies are punished more severely."

Lawrence Summers on Mexico
The Economist, 23 December 1996

The bottom line

"The bottom line on competitiveness is that national economic policies make a profound difference to economic growth in the medium term. Open markets, lean government spending, low tax rates, flexible labour markets, an effective judiciary and stable political system, all contribute to economic growth on a reliable and sustained basis."

Global Competitiveness Report, 1996

I. INTRODUCTION

1. The quality of a country's economic policy and the integrity with which that policy is implemented are crucial factors for its prosperity. Compared to these factors, natural resources are usually of strictly limited value to a country - a fact attested by the existence of many poor but resource-rich countries, and rich but resource-poor countries. Cultural factors such as the capitalist ethic and civic trust are much more important for prosperity than natural endowments, yet a poor policy framework will still prevent even the most promising cultural conditions from being realised in the best economic outcomes.

2. It is true that a rich country may often be able to "carry" a poor policy framework for a period of time before its underlying contradictions become too pressing and demand to be addressed, whereas a poor country with an inadequate policy framework more often and more rapidly reaches crisis point. But rich or poor, a country cannot indefinitely blame inferior economic performance on international trading conditions or other such factors.

3. At the end of the day - and no matter what the characteristics of an economy, prolonged low growth, high unemployment, high inflation and indebtedness are effectively political choices. For instance, a country with high unemployment resulting from inflexible labour market practices effectively makes a political choice to retain its unemployment level. That country could choose - as New Zealand has done - to tackle vested interests through liberalizing its labour market, but instead chooses to continue to engage in a conspiracy against jobs.

4. Over the past two decades a growing consensus has emerged as to what constitute good policy choices. At the micro-economic level, orthodox economics stresses the role of open and competitive markets in creating wealth. As the Secretary-General stated in his speech before the World Economic Forum, "market forces are essential for sustainable development". At the macroeconomic level, there is a recognition that monetary and fiscal policies should not be used in an activist sense to attempt to boost short-term economic activity, but instead should be conducted so as to provide a stable and predictable overall climate that does not compromise good medium-term private sector outcomes - monetary policy by targeting price stability, fiscal policy by running roughly balanced budgets over the course of the business cycle.

5. The New Zealand reforms took place under two Governments, starting in 1984, and in the course of 10 years transformed its economic performance. Few other countries have undertaken reforms of such mutual consistency. As the Organisation for Economic Cooperation and Development (OECD) put it in its latest survey of New Zealand: "While other OECD countries have pursued similar policies, few, if any, have done so in the context of such a coherent overall framework, stressing predictability, transparency and accountability."

6. The key principles driving the reforms included:

(a) The abandonment of current account balance as a direct objective of government policy;

(b) The abandonment of fiscal policy as a means of short-term fine tuning, and instead the adoption of a medium-term fiscal strategy aimed at controlling government spending and eliminating the deficit;

(c) The assignment of monetary policy to the sole objective of achieving and then maintaining price stability;

(d) An abandonment of the use of economic policy instruments for distributional objectives, and an acknowledgment that concerns over income adequacy, or over the distribution of income, are best addressed explicitly through the tax and benefit system;

(e) A new emphasis on the value of competitive markets and the role of the price system in the efficient allocation of resources;

(f) A determination to expose New Zealand business, where possible, to international competition, without subsidies, tariffs or other artificial barriers;

(g) A belief that the tax system should be as neutral as feasible between different types of activity;

(h) In all areas of policy, a concentration on the medium-term implications of policies rather than their short-term effects.

7. At the heart of the reforms was a recognition that resources had not been well employed in New Zealand, and that only by exposing industry to market forces and to much greater international competition could New Zealand's economic performance be transformed. There was thus an explicit philosophy of economic liberalism: free markets were seen as the chief engine of medium-term economic growth. There was also an appreciation that the excessive short-term focus of macroeconomic policies had been severely damaging to the economy. Monetary and fiscal policy needed to be brought under control, to support the growth objective.

8. While "market" economic thinking has gained in currency in recent times, economics has in fact long stressed the importance of markets involving private property and free exchange under the rules of contract. There are very good reasons for this emphasis. A market economy is based on the idea of mutual gain. It enables its participants to specialize in what they do best and voluntarily to trade their goods and services with others. If a transaction takes place voluntarily, clearly both parties to the transaction expect to gain by it, or it would not take place at all.

9. A market economy thus constitutes a social institution by which, through cooperation, numerous trades take place that are mutually beneficial to those concerned. In this process, prices play a crucial role. They summarize widely dispersed information on resource scarcities and consumer preferences. By following price signals, participants in a market have strong incentives to undertake activities that are of benefit to society as a whole.

10. The superiority of competitive markets, where prices are free to move in line with market signals, over heavily regulated markets or production by a bureaucracy is based largely on two key considerations - information and incentives. Information is held in a highly dispersed form in any economy (market or otherwise), but the price mechanism of a market economy allows it to make far better use of this information than is possible under central planning. And the more competitive the market, the greater the incentive on those producing and distributing the goods or service in question to do so efficiently and to keep costs down; in competitive markets, producers have a direct interest in satisfying the needs of consumers.

11. A competitive market allows a much greater variety of ideas and approaches to come into play than in the case of a heavily regulated market or monopoly. In the latter case, only the knowledge or ideas of a limited group of people will be tested. But where the market is competitive, a much greater degree of experimentation is possible. Bad ideas will not last long in a competitive market. However, good ideas spread through being seen, rewarded and imitated. And because market prices will tend to change in such a way as to offset shortages or surpluses that arise, competitive markets are the most efficient mechanism for ensuring resources are fully employed.

12. Essentially the same reasons that lead New Zealand to favour competitive domestic markets also lead the country to strongly favour free international trade in goods and services.

13. The intellectual case for free trade has been strong ever since David Ricardo pointed out, early last century, that two countries can each become better off by specializing in goods in which they have a comparative advantage and trading those goods with each other at a mutually satisfactory price.

14. An economy based on private property and market exchange does not, of course, imply no role for government. The Government has a crucial role to play in providing a sound legal framework so that transactions can be undertaken with confidence. Laws need to be clear and mutually consistent, and enforced through the courts efficiently, competently and with a minimum of corruption. It is a sad irony that while Governments around the world take on so many tasks for which they are unsuited, most do poorly on this most basic of functions. Governments also have a legitimate role in various areas of social policy, particularly in ensuring that high-quality educational opportunities are in reach of all its citizens.

15. In recent times, the resurgence of market liberalism worldwide and the evident failure of planned economies have led to numerous countries undergoing economic liberalization programmes. But in either the developed or developing world, no country has undertaken such an extensive programme of restructuring as New Zealand. As a result of the New Zealand reforms, few rich countries now possess a greater economic freedom or an overall economic framework more consistent with the tenets of mainstream economics. For that reason, New Zealand's recent economic renaissance is of relevance to rich and poor countries alike.

II. THE NEW ZEALAND REFORMS - AN OVERVIEW

16. Though a relatively rich country, New Zealand by 1984 had been reduced to "poor country status" by first world standards, as a result of poor policy choices. A heavily overregulated and inefficient domestic economy, high protective barriers, and inconsistent and irresponsible monetary and fiscal policies had led to New Zealand having the worst productivity growth rate and the worst economic growth per head of any country in the OECD.

17. By 1984 the country was also approaching crisis point, since the rapid build-up in government and overseas debt - another OECD record - had become unsustainable. New Zealand's exports, though growing more diversified, were still dominated by bulk unprocessed pastoral products - essentially a third world country's export base. The poor economic performance could no longer plausibly be blamed on external influences: the country had run out of excuses as an economy and the need for reform was undeniable.

18. One of the most distinctive features of the New Zealand reform programme was its concern with the concept of "government failure", as understood by theorists of the public choice school. In general, Governments can be expected to act in their own self-interest; there is no guarantee they will follow policies that maximize the overall welfare of their citizens.

19. In New Zealand there was a search among policy makers for institutional rules that would bind Governments, as much as possible, to sound macroeconomic policies, even when the short-run incentives of Governments are for unsound policies. Measures such as the Reserve Bank Act 1989 and the Fiscal Responsibility Act 1994 can only be understood in this context.

20. The key initiatives of the decade of reform can be summarized as follows:

(a) The floating of the New Zealand dollar;

(b) A series of measures to bring greater focus, discipline and transparency to government spending, including the State Sector Act, the Public Finance Act and the Fiscal Responsibility Act;

(c) Reform of social transfers with the aim of containing costs and concentrating government assistance on the needy;

(d) The Reserve Bank Act, conferring price stability as the primary goal of the central bank;

(e) The corporatization - and in many cases privatization - of State trading activities;

(f) The introduction of a flat-rate value-added tax (GST), cuts in marginal income tax rates, and a series of measures to broaden the tax base and eliminate anomalies in the tax system;

(g) Deregulation of the financial sector, including the abolition of exchange controls, the lifting of interest rate controls, the abolition of

reserve asset ratio controls on banks and the development of a new regime of prudential supervision;

(h) The introduction of freedom to contract in the labour market through the Employment Contracts Act;

(i) The elimination of most direct subsidies to both pastoral and manufacturing exporters, the phasing out of import licensing and the substantial phased reductions in tariffs towards low or zero rates;

(j) Other deregulations, including the removal of a number of specific price controls, the liberalization of air services and coastal shipping, and the introduction of competition into electricity and telecommunications.

21. These reforms reflect in large part the framework for development espoused by the Secretary-General as he spoke before the World Economic Forum:

> The United Nations has established and is promoting a common platform for development action ... Our detailed work in this area has included assistance for public administration reform, for economic restructuring, for privatization programmes and for essential infrastructure, as well as the strengthening of legal and regulatory frameworks. We set the international norms and standards that make progress possible.

22. Some of these reforms are by no means unique to New Zealand. In many areas, however, New Zealand has been a pioneer. For instance, the Reserve Bank Act and the series of public sector reforms culminating in the Fiscal Responsibility Act show New Zealand to be a world leader. New Zealand has also achieved one of the freest labour markets of any OECD country, as well as the least distorted tax system.

23. There were two major waves of reform. An initial wave of rapid but uneven liberalization was undertaken by the Labour Government elected in 1984. A second wave of reforms, which included the liberalization of the labour market and the reining in of government overspending, removed the final major anomalies in the policy framework and set the scene for economic recovery. This final wave of reforms was undertaken in the first term of the 1990 National Government.

24. A crucial component of New Zealand's reforms was the strong commitment from key political players. The most successful periods of reform were characterized by a clear strategy among ministers and a consistent application of that strategy throughout the public sector. The poor performance of the economy and the powerful vested interests opposed to change meant that a sense of urgency was important in maintaining the momentum of reform. Also important was the placing of high quality people in key public sector positions, to ensure that the vision of the reformers was not frustrated during the implementation stage by a bureaucracy resisting change.

25. Effective communication of the rationale for the reforms was crucial. Business needed to understand the reform strategy so as to be in the best position to realize its benefits. And a sufficient percentage of the public

needed to be persuaded to give reform the benefit of the doubt during a testing initial period when the adjustment costs outweighed any tangible benefits. Securing the support of key private sector groups to the cause of reform was an important factor in securing public acceptance of the liberalization programme.

26. So too was the overall resolve of the Government: as the reforms proceeded, sector groups typically gave up demanding to have their privileges restored and instead started urging the Government to treat them evenhandedly by moving to reform those sectors that were not yet liberalized.

27. After coming through the difficult initial period, the New Zealand economy has now performed so robustly that the reforms have been described by the OECD as "remarkably successful". Since economic recovery began in 1991, growth has averaged between 3 and 4 per cent per annum; unemployment has fallen to 5.9 per cent (one of the lowest rates in the OECD); and the Government's budget has swung into surplus, allowing taxes to be cut while simultaneously paying off all government overseas debt.

28. Private sector investment has been expanding. New Zealand's credit rating has been upgraded. The export sector is today much more diversified and sophisticated than prior to reforms. Surveys such as that of the World Economic Forum have placed New Zealand among the leading nations for competitiveness. And the German anti-corruption organization Transparency International has named New Zealand the least corrupt country out of 41 it surveyed - a reflection both on its culture and on the degree of economic freedom now possessed by New Zealanders.

29. With all these favourable outcomes, it is no wonder that the Financial Times stated that "New Zealand has demonstrated that orthodox economic reforms, energetically executed, can make a difference to an economy's prospects. For this reason, it offers important lessons"; the most important of these lessons are:

(a) The value of comprehensive reform. The New Zealand reforms were both micro-economic and macroeconomic. They encompassed capital and labour markets, goods markets and the government sector;

(b) The importance of balance in reform. The New Zealand economy began its period of sustainable economic growth only after the last principal obstacles to growth (namely an inflexible labour market and government overspending) had been effectively tackled;

(c) The value of a medium-term focus. All New Zealand's principal reforms had such a focus;

(d) The value of political commitment, a clear strategy and high-quality implementation by key people;

(e) The importance of effective communication and a sense of urgency in reform.

III. THE QUEST FOR SUSTAINABLE DEVELOPMENT: GETTING THE CRITICAL POLICY CHARACTERISTICS RIGHT

A. Role of monetary policy

30. It is a well-established empirical finding that over the medium term monetary policy can only favourably be used to influence the level of prices. Relaxing monetary policy in order to boost growth or employment can only work, if at all, in the very short run. Eventually the expansionary effect evaporates and the looser monetary policy flows through into inflation - which itself has harmful economic effects. For this reason, there is a growing recognition worldwide that monetary policy should be aimed simply at maintaining price stability and should avoid erratic swings that exacerbate the business cycle.

31. However, the fact that monetary policy can have a short-term favourable impact on activity presents a problem for the institutional design of monetary policy. Many politicians - and especially those in democratic countries facing periodic re-election - have notably short-time horizons. There is often a temptation for politicians to relax monetary policy, since the adverse effects of such an initiative are largely delayed until a future time.

32. Moreover, the problem is not solely one of how to constrain the worst instincts of politicians. Even if the monetary authorities are responsible, they still have to convince the private sector that they will act responsibly, when the private sector knows the authorities have a short-run incentive to inflate. Managing private sector expectations is important, since the more confident is the private sector that monetary policy will be aimed at price stability, the lower will be risk premium in interest rates.

33. New Zealand's solution to this problem was to give its central bank operational autonomy, combined with a statutory mandate for price stability. The Reserve Bank of New Zealand Act 1989 specifies stability in the general level of prices as the primary function of the bank. A public "Policy Targets Agreement" must be agreed between the Reserve Bank Governor and the Minister of Finance. The Bank has day-to-day autonomy.

34. However, twice-yearly it must produce a detailed monetary policy statement, which is tabled in parliament and examined by a parliamentary select committee. A Government can temporarily direct the Reserve Bank Governor to conduct monetary policy in accordance with an aim other than price stability, but such an action (which is most unlikely to occur) must again be transparent: any such "override" would need to be tabled in parliament.

35. The public nature of the override, combined with the open nature of New Zealand's capital markets, makes it unlikely the override will be used. A loose monetary policy only succeeds in boosting activity in the short term if it "fools" participants in the economy into thinking that there has been an increase in real demand for their services when there has only been a paper increase in demand. In a public override this "surprise" effect is mitigated.

36. All in all, the single objective, transparent contracting and explicit accountability mechanism of New Zealand's Reserve Bank Act represent a strong

institutional commitment to price stability. By making that commitment, the Act adds to the credibility of monetary policy and lowers the inflation risk premium built into interest rates.

B. International perspective on monetary policy

37. Internationally a politically and operationally independent central bank is the exception, not the rule. In too many cases, Governments view monetary policy as a convenient weapon to be wielded when the fiscal going gets too tough. In a highly damaging fashion, Governments have often resorted to an attempt to inflate their way out of their difficulties.

38. In an effort to mend such disreputable ways a number of strategies have been employed to win greater credibility in the fight against inflation.

39. Argentina has embraced the concept of convertibility; a fixed peg of the peso against the United States dollar. In effect Argentina conducts its monetary policy by proxy - i.e. it relies on the United States Federal Reserve to conduct its monetary policy.

40. While Argentina will eventually have to graduate to its own home-grown monetary policy, as a transitional stance a convertibility policy has helped to build credibility. In direct contrast it is very hard to build credibility when, as in a country like El Salvador, the governor of the Central Bank is also a member of the Cabinet.

41. Winning credibility in the conduct of monetary policy is not just a problem that developing countries wrestle with. The European Monetary System (EMS) is in effect a signup by participating nations to the monetary policy of the German Bundesbank. As the spectacular exit from the EMS of Italy, the United Kingdom and others on "Black Wednesday" in 1992 demonstrated, external norms cannot survive in the face of contrary domestic policy settings.

42. Countries rich and poor are debilitated by high inflation. But high inflation steals in particular from the poor and those on low and fixed incomes. Given that there is a high degree of correlation between central bank independence and low inflation, it makes sense to move to New Zealand's highly creditable model.

IV. CEMENTING RESPONSIBLE FISCAL POLICY

43. Fiscal policy represents a similar - though more complicated - challenge of constraining government so that its conduct of policy is consistent with sound medium-term objectives. Persistent budget deficits harm savings and investment and compromise the long-run growth of its economy in favour of immediate consumption. Yet public ignorance, the short-time horizons of politicians, and the nature of the political lobbying pressures to which Governments are subject, all conspire to produce frequent overspending and fiscal deficits.

44. This suggests that countries need an institutional mechanism for entrenching, as far as possible, responsible fiscal behaviour over time. But overly simplistic fiscal rules - such as a requirement for the Government to balance its budget each year - suffer from a variety of theoretical shortcomings and do not have a good record in practice.

45. New Zealand's solution to this problem was the Fiscal Responsibility Act 1994. This Act establishes a statutory framework for the responsible conduct of fiscal policy, and seeks to reverse the institutional and political bias that leads over time to increasing government spending and debt-financed fiscal deficits. It is designed to achieve for fiscal policy what the Reserve Bank Act has achieved for monetary policy.

46. There are two essential elements to the legislation. The first is a set of principles of fiscal responsibility, which provide explicit guidelines for the prudent conduct of fiscal policy. These principles include running balanced budgets "on average, over a reasonable period of time" (i.e. over the course of the business cycle), reducing government debt to prudent levels, and pursuing policies consistent with a reasonable degree of predictability in future tax rates. These principles do not constrain an elected government from making a full range of expenditure decisions in line with its social priorities.

47. Under the Act, a Government is still free to specify the broad strategic priorities by which it will be guided in preparing the budget. It can - and should - advance its economic and social policy ambitions. But the existence of the fiscal principles does ensure that a Government's objectives will be pursued in a fiscally responsible manner.

48. The Fiscal Responsibility Act also recognizes that Governments may on occasion be forced temporarily to depart from the principles of responsible fiscal management. However, when it does so, a Government must justify this departure and outline how it intends to return to policies consistent with the principles of responsible fiscal management.

49. Just as important as the principles to ensure responsible fiscal management is a commitment to fiscal openness. The Act is designed to ensure a high degree of public and parliamentary understanding of the parameters within which the budget is being prepared. At least three months before the start of the fiscal year, the Minister of Finance publishes a Budget Policy Statement - a strategic document setting out the Government's broad priorities for fiscal policy.

50. Thus, the Act exposes to parliamentary scrutiny and private contestability the basis on which the Government is preparing the budget before it is finalized. This leads to a wider sense of ownership of the budgetary issues that the Government must address.

51. The Act also requires a detailed set of three-year economic and fiscal projections to be published at budget time, along with an assessment of fiscal policy in the context of the principles of responsible fiscal management. It further requires a second set of three-year economic and fiscal projections to be published halfway through the fiscal year.

52. In addition, the Act requires a full set of three-year projections to be published just prior to a general election, so as to enable all political parties and the wider public to debate issues and to advance policy with the best possible information on the state of the country's books. The temptation for political parties to engage in an electoral auction in the run-up to an election is greatly reduced when the true state of the Government's books must be disclosed prior to an election.

53. The principles of fiscal responsibility in the Act, together with the high level of fiscal disclosure, provide strong incentives for Governments to operate fiscal policy in a responsible manner. The Act has already helped change the nature of political dynamics and the wider policy debate: the current coalition government wishes to be seen as "fiscally responsible" in terms of the legislation, while the private sector regards compliance with the Act as a key aspect of responsible economic management.

54. The Fiscal Responsibility Act, in conjunction with the Reserve Bank Act, has given New Zealand what Economist magazine has described as "the world's best" fiscal and monetary policies.

A. Global experience in managing fiscal pressures

55. Governments around the world are plagued by debt and deficits. In some cases the culprit is a political unwillingness to face up to a decline in the nation's earning power. Those nations will typically live beyond their means, borrow and hope to postpone the day of reckoning for as long as possible. Debt is the disreputable legacy for the next generation, and increasingly a blight on current performance.

56. In other cases, typically in the developed Western world, the rate of increase in special entitlements is outstripping those nations' capacity to pay. External disciplines such as compliance with the Maastricht Treaty demands or crude balanced budget amendments are employed in an endeavour to bring these nations into line on the deficit.

57. Deficit and debt difficulties of a completely different order of magnitude are experienced by the world's lamest economies where the starting point is decades of abysmal performance. Yet the economic imperatives are the same.

58. High rates of domestic savings are essential for sustainable development. The first and worst sinner when it comes to savings is generally the government of the day, which has been typically "dis-saving" for generations. In the quest to secure macroeconomic credibility, so essential for the flow of foreign capital, sound monetary policy must be matched by the practice of fiscal responsibility.

59. In an open market economy the sanction for a policy lapse on either count is swift and savage.

B. Transforming the public sector

60. As stated in a 1995 OECD report, "Governance in Transition: Public Management Reforms in OECD Countries", a variety of factors have come together to make reform a burning issue. Key among these are:

(a) The development of a global market place, which highlighted the impact of government activities on national competitiveness;

(b) A perception that public sector performance was inferior to that of the private sector;

(c) Concern that the public sector was squeezing out the private sector;

(d) Limits to future growth of the public sector, given budget deficits and high levels of public debt;

(e) A lowering of expectations about government's ability to solve economic and societal problems by traditional remedies;

(f) Citizens' demands for improved responsiveness, choice and quality of service;

(g) Demands from public service staff.

61. Put together, these pressures have resulted in a reappraisal of the rationale for government intervention and a re-examination of public sector management and performance.

62. Many countries around the world are coming to appreciate the shortcomings of the institutional environment under which government bureaucracies have often operated. Objectives are often confusing or conflicting, accountability is weak, incentives for efficiency are minimal, and management is hamstrung by overcentralized decision-making and excessive bureaucratic rules.

63. In this environment, resistance to change typically becomes endemic, and the bureaucracies are run as much for the benefit of public sector workers as for serving the interests of the wider public. Such a self-serving public sector certainly characterized New Zealand prior to its economic reforms.

64. Reforms start with a first rethinking of the principles of the entire role of the State. Over time, Governments become greatly over-stretched: they undertake many activities where they have no legitimate role and generally end doing badly those things that do constitute its core functions.

65. The task facing reformers is to decide upon those areas where the State has a legitimate role, then determine in each instance how that role can be most efficiently and effectively carried out. This inevitably means a reduced government presence in the economy, as well as a transformation in how the State undertakes its remaining functions.

66. Typically, the State's roles include regulating private sector activity, producing many goods and services itself, and providing social services. In truth the State is often both player and a referee. It should confine itself to the referee or regulator function. As regulator, the State takes on a much less obtrusive role through its core function of setting the legal framework against which open and competitive markets can operate. This remains, of course, a quite crucial function of government. The ideal is to combine generally sound law with an uncorrupt, independent and relatively competent judiciary, and thus to score highly as an economy where the rule of law is upheld.

67. A Government should also reduce its role as a participant in economic activity through corporatizing and privatizing many State trading activities. As concerns the provision of social services, by contrast, most changes have concerned how the Government discharges that function, rather than involving a reduction in the overall government presence.

68. A decade of reforms to New Zealand's public sector has led to a model of public sector management that has brought world acclaim. The new public sector model starts at the strategic level, where cabinet ministers decide on their key priorities. As the only participants with democratic legitimacy, ultimately it is the ministers who can set the desired social and economic outcomes that are to result from government action.

69. Each year a document is produced setting out the Government's vision of the outcomes it wishes to see achieved in the years ahead. In advance of the presentation of the budget the Government also publishes a Budget Policy Statement - another strategic document incorporating the Government's economic and social ambitions. This document binds the whole of the Government to the published strategy.

70. In line with the strategy, individual ministers in turn choose the outputs they wish to purchase from their departments and from other State entities in order to help realize the outcomes sought by government. The chief executive of each department is responsible for providing the relevant minister with the contracted outputs. The chief executive is on a fixed-term contract and has wide discretion to manage departmental inputs - including labour.

71. Labour practices are flexible, with unionism voluntary and a large percentage of State sector workers covered by individual contacts (as is also the case in the private sector). Pay-by-performance is commonplace. Often tasks are contracted out to private sector organizations that can perform the function more efficiently; there is no presumption that Government is the preferred provider.

72. Besides purchasing outputs, the Government also has an "ownership" interest in the assets tied up in government agencies. In the core State sector each department must now calculate a balance sheet, and a system of capital charging has been introduced. These twin disciplines provide a powerful incentive for departmental chief executives to manage their balance sheet and to make the most efficient use of their assets.

73. It is, however, in the area of State trading activities where the Government's ownership interest has been most radically reassessed. Prior to the reforms, most trading activities were contained in government departments, which faced poor incentives, bureaucratic controls and often mixed objectives. Service was notoriously poor, and many activities ran permanently at a loss. Under the reforms, these activities were separated out into distinct organizations, becoming State-owned enterprises (SOEs).

74. SOEs are registered under the Companies Act and are required to operate in most respects as private companies. They have a clear profit objective and boards that are largely free from political control. They must borrow on their own account and pay tax and dividends to the Government. Nor are they shielded from facing private sector competition. Day-to-day running of an SOE is in the hands of its board and management. The shares are held by two share-holding ministers. The sole task of the share-holding ministers is to manage the taxpayer's ownership interest by appointing the board, setting dividend policy, and monitoring overall performance.

75. Under the improved incentives provided by the new regime, there were some huge productivity increases following corporatization. New Zealand Telecom, the new communications SOE, almost doubled its productivity; the new coal SOE managed to cut its total workforce in half during its first year in operation while increasing output; and the railways reduced its staff numbers by almost two thirds over a four-year period while carrying increased tonnage. These efficiency gains were not captured by the corporations themselves; they were passed on to consumers in the form of lower prices and - frequently - better services:

(a) Electricity prices fell by 13 per cent; telecommunications prices fell by around 20 per cent, as did coal prices; rail freight rates were halved; the price of posting a standard letter fell substantially over time; while the new port companies also achieved major reductions in prices;

(b) Almost all the SOEs became more customer-focused than their predecessor organizations had been. For instance, the average waiting time for installing a new telephone came down from six weeks to two days.

76. There were also benefits for the taxpayer. The great majority of SOEs soon ran as profitable businesses, in some cases reversing years of loss making. As a group, the SOEs increased their return on shareholders funds by around 75 per cent in just one year. Through their tax and dividend payments, they became a significant source of revenue to the Government.

77. While these developments were welcome, in the case of the great majority of SOEs there were strong economic reasons for taking the further step of transferring the business to the private sector. Only in the private sector would productivity be maximized, and each business best placed to undertake new investment.

78. Corporatization was a halfway house, and the performance incentives and monitoring mechanisms under government ownership - while much improved - still

did not match those available in the private sector, where shares were freely tradable and companies subject to takeover.

79. State-owned businesses also carry a genuine risk of policy slippage over time. Political fashions can change, and commercial considerations can easily become increasingly subordinated to political considerations once again, given the often short-time horizons of the political process. The slow infiltration of politics into SOE policy can be manifested in terms of soft required rates of return, interference in key decisions such as pricing, or excessively political board appointments. For all of these reasons, a major privatization programme was undertaken in New Zealand.

80. A successful privatization programme will have clear objectives and a well understood process for conducting the sales. In New Zealand the objective was to maximize the value of each asset sale to the taxpayer. Other objectives - such as a desire to spread popular capitalism or to redistribute income from one group to another - did not play any substantial role.

81. Thus in New Zealand an economically pure approach was taken. By seeking to get the best possible price for each asset, not only were the interests of the taxpayer directly served, but the wider interest of economic efficiency was also served, since those purchasers who are prepared to pay the highest price are, in general, those in the position to use those assets in the most efficient manner.

82. In New Zealand it was considered important, in any asset sale, for the regulatory framework of the relevant industry to be satisfactorily resolved before the sale took place. This gives maximum certainty to all the players involved. Nor was the mistake made of selling off State monopolies in such a way that they merely became private monopolies.

83. Deregulation and contestable markets were becoming the norm under the New Zealand economic reforms. Where an industry had some characteristics of a natural monopoly, the preferred approach was still one of contestable markets (as far as possible) allied to light-handed regulation.

84. Like the regulatory environment, legislative authority for an asset sale should be completed before the formal sale process gets under way. If the Government is seeking to maximize the price received, it should avoid attaching arbitrary conditions in legislation that may have a political motive, but which devalue the sale process. If a large number of assets are being privatized, generic legislation is desirable. In New Zealand's case, all the SOEs had been set up under the State-Owned Enterprises Act 1986. Since, under the Act, the Government held the shares in these companies, selling those shares to the private sector required no new legislation.

85. Once a sale gets under way, the transparency and the integrity of the process are important to maintaining confidence. The sale process should be run in as commercial a manner as possible. The maximum feasible amount of information should be provided to bidders. The sale should not be tied down to a fiscal timetable. If an asset is being sold so as to "improve" one year's fiscal numbers, it is being sold for the wrong reason.

86. Such an approach risks leading to rushed sales, mistakes in the sale process and compromises on price. For that reason, the Minister of Finance deliberately did not write the projected proceeds of asset sales into any fiscal forecasts. All proceeds from asset sales were dedicated to retiring debt.

87. In New Zealand's privatization programme, assets totalling around $14 billion were sold. Most sales were by open tender, and many assets went to overseas interests.

88. The wholesale separation of commercial functions from other functions of government departments in New Zealand has been one aspect of an overall programme of restructuring the public sector so as to make objectives and accountability more unambiguous. Thus the provision of policy advice has typically been separated from the operational functions of departments, partly so as to remove any conflict of interest from those involved.

89. For similar reasons, the funding of activities has been separated from their provision. Regulatory functions have also been isolated into separate agencies. In any given area of policy, there is likely to be a small ministry giving policy advice and other agencies acting as purchaser or provider. Almost the whole of the public sector has been restructured along these lines.

90. Any Government that takes seriously its role as purchaser of outputs and as owner of assets will put in place sound systems to measure performance. Here, too, the New Zealand public sector model leads the world. Information requirements right through the public sector are substantial. In line with the new stress on outputs, all departmental reporting and financial accounting is on an output basis.

91. At the aggregate level the New Zealand Government now calculates an annual operating statement on an accrual basis, as well as a consolidated balance sheet for the whole of the State sector - the only country in the world to do so. Fiscal projections are also open and transparent. By law the Government must produce and publish twice-yearly economic and fiscal projections, including a set of forecasts just prior to each general election.

V. INTERNATIONAL TRENDS TO REINVENT AND MODERNIZE GOVERNMENT

92. The quest to modernize the State has swept the world. All nations whether rich or poor want government that "works better and costs less". Reform approaches range from the radical (New Zealand) to the innovative (United Kingdom's Next Steps) to the incremental (much of Europe, Latin America and Asia).

93. The distinguishing feature of New Zealand's approach is its comprehensive nature - the reforms cover the whole of government, including the core State sector. In contrast, the United Kingdom's reforms created a series of agencies out of those parts of traditional departments that were providing services to third parties. The core of the United Kingdom's government administration is only just embarking on human resources and financial management reform.

94. Malaysia has undertaken a public sector management reform programme in a more incremental way, by seeking to move the focus to results. A client charter concept is being introduced that promotes total quality management and consultation with the public about the standards of service provided.

A. Accountability, predictability and transparency

95. The New Zealand public sector reforms rate highly on three important principles of good governance - accountability, transparency and predictability. Accountability in New Zealand has been enhanced at all levels. Departmental chief executives are now directly accountable for their performance in delivering their department's outputs, and even ordinary employees are more accountable than under the old union-dominated State sector.

96. The outputs of a department are now clearly specified. Both ministers and the wider public can see what they are buying, how much it costs, and who is responsible. Privatized SOEs now face the disciplines of the competitive marketplace. Those SOEs that for various reasons have not yet been privatized still face much increased accountability: share-holding ministers seek an economic rate of return on the taxpayer's assets and are empowered not to reappoint directors after their terms have expired.

97. There are other means by which accountability in government can be strengthened. Free and open financial markets are an important ally of good government. They sit on daily judgement over a country's economic policy and bring home to a Government visibly, and rapidly, the medium-term consequences of poor policy.

98. Where asset prices appear misaligned, they usually reflect underlying imbalances in economic policy. By so doing, they put pressure on policy makers to address those imbalances. In New Zealand the liberalization of exchange controls and interest rate controls in the mid-1980s, along with the clean float of the New Zealand dollar, played an important role in encouraging Governments to adopt prudent policies, especially in the area of fiscal and monetary policy.

99. The New Zealand model rates equally highly in terms of transparency. Clear operating rules and a free flow of information assist economic decision making, reduce uncertainty and increase confidence in the legitimacy of a Government (whether democratic or not). New Zealand has an Official Information Act policed by an independent Ombudsman. That legislation sets down the general principle that information should be made available in the absence of compelling reasons otherwise. Crown-owned entities report regularly to Parliament, while New Zealand's fiscal reporting is the fullest in the world. The Government's overall fiscal strategy must be disclosed in accordance with the requirements of the Fiscal Responsibility Act.

100. Other important arms of economic policy typically operate also under substantial transparency requirements. It has been noted, for instance, how the Reserve Bank Act sets down a highly transparent framework for the conduct of monetary policy.

101. Where policies are transparent and accountable they are likely also to be predictable in their impact. Thus it is in New Zealand. Monetary policy furnishes a good example: the operational autonomy of the Reserve Bank, its single and explicit objective, and the transparent contracting between Government and Bank lends policy a high degree of predictability.

102. Similarly, the transparency and medium-term focus of New Zealand's public sector management model lend increased predictability to fiscal policy. The requirement in the Fiscal Responsibility Act to run a balanced budget over the course of the business cycle, along with the high level of information disclosure required by the Act, is an explicit mechanism for entrenching over time sound fiscal outcomes.

B. Taxation

103. All taxation imposes substantial indirect costs on a community, over and above the direct costs of the taxation. These indirect costs largely arise from the reduced incentive to work, save and invest resulting from the imposition of tax. The principal question of tax design is how to minimize these costs. A soundly-designed taxation system will have low rates of taxation applied over a broad tax base, and except where compliance costs make it infeasible, it will generally avoid applying a different rate of tax to different economic activities.

104. A selective tax system encourages tax-driven investment. This is contrary to the welfare of the community as a whole, since certain investment decisions will proceed, not because they have a high economic return, but purely because of their tax advantages, while other investment opportunities will in comparison be arbitrarily penalized. A well-designed tax system will also avoid high marginal tax rates, since these lead to high losses in terms of foregone economic activity.

105. As well as involving sound tax design, tax laws need to be competently and consistently enforced by the agency responsible for collecting the tax. If that is not the case, the economic consequences will be as serious as badly designed tax laws. Enforcement will be easiest in countries where there is a culture of compliance with the law, but the incentives for corruption and tax evasion will be highest when tax rates are highest - another reason why law tax rates applied over a broad tax base is a sound tax strategy.

106. Prior to the economic reforms, the New Zealand tax structure had been poor by the standards of other OECD countries. It was heavily reliant on direct rather than indirect tax, contained numerous loopholes and, unsurprisingly, had resulted in very high marginal rates of direct taxation. The tax system discouraged work effort and greatly distorted investment decisions. In the course of the economic reforms, the balance of the tax system was shifted more towards indirect tax, loopholes were progressively closed, and marginal rates of income tax were lowered substantially.

107. The centrepiece of the tax reforms was a flat rate value-added tax, levied on virtually all goods and services. The Goods and Services Tax (GST) replaced

the existing varying-rate sales tax and allowed marginal rates of income tax to be substantially cut. Difficult to evade, easy to comply with and even in its incidence, GST proved a model of tax reform. Other reforms were also made to broaden the tax base and eliminate loopholes in both company and personal tax. Already by 1989, the OECD was calling New Zealand's tax system "probably the least distorted in the OECD".

C. Reforming the labour market

108. Poor labour market outcomes - particularly in the form of unemployment - constitute one of the most serious problems facing many Governments today. Yet unemployment is not an insoluble problem: orthodox economics tells us how to go about combating it and which misconceptions to avoid. A mistake too often made is to view the labour market as somehow fundamentally "different" from other types of market.

109. The labour market certainly has special characteristics, but the similarities between labour markets and other types of market are of much greater significance than the differences. The same reasons that lead mainstream economics to favour open and competitive markets also provide powerful arguments for flexible labour markets with a minimum of regulation.

110. Like any other, the market for labour services involves a common interest between buyer and seller. The buyer of labour services is the employer, the seller is the worker. Their common interest is best met by maximizing the potential for voluntary cooperation between them. Both parties have the information and the incentive to maximize the benefits from any agreement.

111. At the same time, the interest of society as a whole is best met by ensuring competition between employers for the hire of workers and between workers for employers. This maximizes the chances that labour resources will be put to their most productive uses.

112. Accordingly, the key principle should be the widest possible freedom to contract in the labour market. The worker may choose to contract directly with the employee, or he may delegate the task of negotiation to a union. That is up to the parties involved. But the State should not arbitrarily restrict the types of contracts that individual workers and individual employers can enter into.

113. A labour market with a high degree of freedom to contract will have major benefits in terms of productivity, industrial harmony and job satisfaction among employees, but the greatest advantage of a liberalized labour market is its implications for unemployment. A liberalized labour market will keep involuntary unemployment to a minimum.

114. There will always be some degree of frictional unemployment, consisting of those workers who are currently between jobs and searching for work, but so long as labour is reasonably mobile, and so long as there is genuine freedom to contract, workers will before long be able to find buyers for their labour.

115. There is a considerable evidence that flexible labour markets lead to both higher economic growth and lower unemployment than highly-regulated labour markets. The East Asian economies have some of the most flexible labour market regimes in the world and have combined low unemployment with spectacular economic growth and rapidly living standards.

116. The superior flexibility of the United States and British labour markets, in comparison to most continental European labour markets, is widely admitted to be a major factor behind the lower unemployment rates of those countries.

117. Yet despite these examples, many countries' labour markets remain heavily overregulated. Laws ostensibly designed to "help the worker" typically put barriers in the way of job creation. Some of these laws - such as minimum wage laws - directly freeze marginal workers out of the workforce.

118. Other laws can give unwarranted power to certain insiders, who can then use their powers to marginalize the more vulnerable members of the labour force. The persistence and the scope of such laws are largely responsible for unemployment being almost a worldwide phenomenon.

119. Until recently, New Zealand provided a good example of misconceived labour laws. In New Zealand, every worker was covered by a national award setting out the wages and conditions to which they were entitled. The award was negotiated in an annual ritual between the worker's union and representatives of the larger employers, and was then binding on employer and worker alike. Union membership was compulsory, and there was only one union available for any given worker to join.

120. The drawbacks of the regime were not hard to see. Each workplace is unique, yet the same award applied to widely disparate workplaces. Instead of leaving decisions to those best placed to reach agreement on wages and conditions of employment, i.e. workers and employers at the level of the firm, decisions were made by third parties remote from the action. In the process, the scope for many potential productivity improvements was compromised. Good employers were frustrated because they could not innovate through reaching no-strike agreements, making more intensive use of the plant, or developing more flexible remuneration structures.

121. Unions had a monopoly on worker representation, which reduced their incentives to work in the best interests of their members. And the award system was a wage-setting cartel for employers just as much as for workers. As for the unemployed, their interests were not represented in the system at all: they were prevented by law from offering themselves on the labour market on terms and conditions they thought fit.

122. New Zealand's industrial relations system was thus characterized by monopoly behaviour by the "insiders" of the system, at the expense of outsiders. The manner in which it pitched employers against unions in award negotiations led to a strong "adversary" culture between employers and unions. The fundamental common interest between employer and worker was often forgotten.

123. By 1991, when the wider economic reform programme had been under way for six years, the imperative to address the labour market had grown. The vehicle for reform was the Employment Contracts Act (1991) - legislation that represented a radical break from the past. With some exceptions, it ushered in a new era of freedom to contract.

124. Under the Employment Contracts Act, there is very little proscription of the types of contracts employers and workers can enter into. Workers can be covered by a collective contract or by an individual contract. Employers can negotiate a mixture of collective contracts and individual contracts with their workforce. Union membership is no longer compulsory. A worker is free to choose his or her own bargaining agent when negotiating with their employer.

125. Strikes are seen by the Act as a breach of contract and are only permitted where they relate to the negotiation of a collective contract for the employees concerned. All other types of strike - including sympathy strikes - are unlawful. While both collective contracts and individual contracts are permitted under the Act, it does not favour one type of contract over the other. The essence of the Act is choice. Whether to have a collective or an individual contract is itself a matter for negotiation between employer and worker.

126. There are, admittedly, some areas where the Act did not go far enough towards free contracting. One of these is the statutory minimum wage, which the Act failed to repeal. Another was the Act's retention of a specialist legal institution for labour issues. Despite these important limitations, the performance of the New Zealand economy since the Act came into force has exceeded even the expectations of the Act's strongest proponents.

127. The economic upturn began the very next quarter, and New Zealand has enjoyed uninterrupted growth since that time. While its precise impact on the upturn can be debated, the Act was undoubtedly the major factor ensuring that the economic upturn flowed through so strongly into job creation. When the Act came into force, unemployment was nearly 11 per cent. Five years later, the rate is 5.9 per cent. Thus, over a period when unemployment has risen in most OECD countries, New Zealand unemployment fell substantially, and the number of jobs increased by over 230,000, or almost 16 per cent.

128. None of the fears voiced about the Act turned out to have substance. The new regime did not lead to greater industrial disruption: there was a sharp drop in the number of working days lost through strikes. Nor did it lead to cuts in wage rates. There is ample evidence the Act has led to a positive change in the culture of New Zealand workplaces. In 1993 a survey by the New Zealand Institute of Economic Research found that 47 per cent of businesses believed the Act had improved labour productivity in their enterprise; 63 per cent believed it had led to increased flexibility of operations; 29 per cent believed it had led to increases in staff training, while 37 per cent believed it had improved the quality of management. Other surveys have shown similar results.

129. As for employees, a survey last year found that over 75 per cent of the labour force were satisfied with their terms and conditions of employment, their employers and their jobs. There has been a big shift over this period towards

individual rather than collective contracts. Union membership has fallen substantially, but unions have not disappeared from the industrial scene. They are simply having to earn their memberships by providing a service, just like any other voluntary organization.

130. In sum, the economic outcomes of the Employment Contracts Act have borne out orthodox economic theory and have demonstrated that high quality labour market reform is not only possible, but can also be politically durable.

D. Capital markets

131. Free and lightly-regulated capital markets assist economic development by allowing capital to be allocated to its most efficient uses. The rapidity with which financial markets were liberalized early on in the reform programme was a particular feature of the New Zealand reforms. All controls on interest rates were lifted almost immediately, and all exchange controls abolished. The system of reserve asset ratios applying to financial institutions was abandoned.

132. Monetary policy henceforth operated, not by direct controls on individual banks, but by controlling the amount of base liquidity in the total financial system. Any legal distinction between banks and non-banks was removed. Banks receive no government guarantee, but are subject to prudential supervision by the Reserve Bank and light-handed regulation.

133. In March 1985 the New Zealand dollar was floated. Ever since then, the Reserve Bank has run a "clean" float: there has been no buying or selling on the foreign exchange market with the intention of directly influencing the value of the New Zealand dollar. The Reserve Bank is not indifferent to the level of the exchange rate, since it constitutes one of the important mechanisms through which monetary policy is transmitted, but there is no exchange rate target. The Reserve Bank monitors a range of indicators in assessing monetary policy, of which the exchange rate is one.

134. Floating the currency had two principal rationales. It assisted monetary policy by giving the authorities better control over the monetary base than is possible under a fixed exchange rate regime. Moreover, as with any other price in the economy, there were sound theoretical reasons for wanting the exchange rate to be free to move in response to underlying changes in supply and demand.

135. Like other prices, it is a mechanism through which important signals are transmitted to participants in the economy. At least under a balanced policy framework, a floating exchange rate has a role of its own to play in efficient resource allocation.

136. The floating of the exchange rate was certainly successful in gaining independence for New Zealand monetary policy. In the early years of the reforms, however, it is at least arguable whether floating the exchange rate assisted overall resource allocation. This was because of the imbalances elsewhere in the reform programme - particularly the large fiscal deficits which persisted for some years. These deficits often put upward pressure on the real exchange rate, to the detriment of the export sector.

137. For most of its history, New Zealand has had a relatively liberal regime governing inward direct investment. However, on the strength of the economic reforms, New Zealand has become a much more attractive destination for foreign investment than formerly. Between 1989 and 1994, the stock of foreign direct investment more than tripled to around one quarter of GDP. A large percentage of New Zealand's major corporates are now foreign-owned.

138. The Government encourages foreign direct investment and sees it as an important means by which New Zealand can gain new technology, skills and market linkages. Investment was flowing into the country well before the overall economic upturn in 1991 - a clear sign that it was attracted by the new policy framework being developed. Foreign investors have also come to have a very substantial presence in the New Zealand bond market: the percentage of government bonds held by non-residents has risen from 8 per cent in December 1988 to 62 per cent in December 1996.

139. The lesson from New Zealand for other countries seeking capital is that foreign investment will follow a sound policy regime. In the case of developing countries, only 10 per cent of the capital they attract comes from donor organizations; the great bulk of capital is private investment. The global capital market is a reality, and the quality of a country's policy regime is a crucial factor in attracting that investment.

140. Developing countries can help themselves by accepting the need for greater openness. Transparency is essential to a well functioning capital market. Lawrence Summers put the case for transparency very forcefully in the context of discussing the lessons to be learnt from the Mexican financial crisis.

> Full disclosure will attract capital by reassuring the investment community. Moreover, it will promote market discipline, generating a faster response from private analysts and public institutions when trouble looms on the horizon. Most important, the discipline of disclosure fights policy makers' temptation to believe that they can somehow slip and slide their way through problems by making use of clever reporting.
>
> The Economist, 23 December 1996

E. Assistance to industry

141. Governments cannot create wealth, but they can put in place an environment conducive to wealth creation in the private sector. This paper has described many of the elements of the environment favourable to the entrepreneur: a sound legal framework; stable prices; fiscal policy that does not damage private sector investment; a State sector that does not impose excessive costs on the private sector; a flexible labour market; open capital markets; and a competitive and deregulated economy.

142. Other attempts to more directly "help" the entrepreneur are usually self-defeating. Industry assistance in the form of subsidies or tax breaks to specific industries is almost always misconceived. Such assistance encourages investments that would not otherwise have been undertaken, but the fiscal cost

of such measures translates into higher interest rates or higher taxes, with the result that other - more favourable - investments do not take place at all.

143. This type of assistance will only be positive for an economy if the Government is consistently better at picking winners than the private sector. However, there is no reason to believe that the Government has better information than the private sector, and every reason to believe it has worse. Moreover, the incentives on Government are clearly inferior to private sector incentives.

144. Even less can industry assistance in the form of tariffs or other controls on imports be justified. Such policies dissipate some of the gains that a country can make through international trade. Import protection encourages inefficient import-competing industries to develop, while loading costs onto the export sector. It draws resources into activities in which a country does not have a comparative advantage, at the expense of activities where it does. This plainly lowers overall economic welfare.

145. In line with this thinking, both direct industry assistance and import protection have been greatly reduced in New Zealand in recent years. However, there is scope for them to be reduced even further.

F. Speed and sequencing

146. Speed is important in undertaking structural reform, and there is no evidence that slowing down the process of reform yields benefits. For instance in Eastern Europe, those countries that have pressed ahead rapidly with reform have done appreciably better as a group than those where reform has been tentative.

147. However, for political and other reasons, most reform programmes do take place in stages, and there are clearly better and worse sequences in which reform can be undertaken. In New Zealand, the sequencing was far from perfect. A general consensus on the optimal sequencing of reforms might be summarized as follows:

(a) Macroeconomic stabilization should, if possible, take place early. The Government should move rapidly to control the fiscal deficit. If not, poor macroeconomic policy will compromise the gains made in the microeconomic reforms;

(b) Domestic markets - both in goods and in labour - should be deregulated, as much as possible, no later than the reduction in border protection. This will provide import-competing industry with the environment most conducive to competitiveness, before exposing it to international competition;

(c) Financial market deregulation should not occur before substantial progress has been made in liberalizing goods and labour markets and before the fiscal deficit has been brought under control. This caveat particularly applies

to the foreign exchange market: opening up the foreign exchange market too early risks putting excessive upward pressure on the real exchange rate;

(d) The broader the scope of the reform programme and the more clearly it is telegraphed, the sooner will the benefits begin to flow.

148. In New Zealand the sequencing of reforms went roughly as follows:

(a) Financial market liberalization - immediate;

(b) Goods market liberalization proceeded in stages, mainly subsequent in time to financial market liberalization;

(c) Government sector reform proceeded in stages, but fiscal imbalances were not finally corrected until late in the reform programme;

(d) Labour market liberalization - late.

Thus two principal mistakes in sequencing were:

(a) The long time taken to bring the government deficit under control, following deregulation of the financial markets (and in particular the foreign exchange market), which put excessive pressure on exposed sectors of the economy;

(b) The failure to liberalize the labour market early in the reform programme, which compromised the drive to become internationally competitive and resulted in excessively high unemployment during the transition. A third mistake was the uneven pace of goods market reform, in which assistance to exporters was scaled back more rapidly than reductions in import protection. For a time this put added pressure on the export sector.

149. These sequencing mistakes undoubtedly increased the adjustment costs of the New Zealand reforms. The biggest single mistake was probably the delay in implementing labour market reform - a mistake that had severe costs in terms of employment.

VI. CONCLUSIONS

150. The Secretary-General has spoken of the need for a new partnership between Government and the private sector. One can now summarize in what manner, on the arguments of this paper, that partnership should operate. On one side, the Government must provide a framework of policies that are consistent, transparent, predictable and credible. It should not attempt to perform tasks that are the proper province of the private sector, but should rather provide the overall climate within which markets can flourish.

151. Private sector participants, for their part, must be prepared to take the lead in investment decisions and look to their own skills and resources in the search for higher productivity, rather than seek to be rescued by government rules that confer privilege on them while raising costs on others. Private

sector participants must observe the legitimate rules of competitive markets and stay within the law.

152. A policy regime that has realized this partnership with a high degree of effectiveness would look like this:

(a) A monetary policy aimed at price stability, and an institutional mechanism - such as New Zealand's Reserve Bank Act - that effectively locks price stability into the economic framework;

(b) Fiscal policy that does not attempt to be actively counter-cyclical, but which aims to run balanced budgets over the course of the business cycle - preferably with an institutional mechanism such as New Zealand's Fiscal Responsibility Act as a means of cementing in good fiscal behaviour;

(c) A Government sector that is only performing those functions that could not more efficiently be performed by the private sector, and is undertaking those tasks in as transparent and accountable a manner as possible. Commercial businesses belong in the private sector;

(d) A tax system where low rates of tax are conferred over broad tax bases;

(e) Open and competitive markets, without price controls or monopoly powers conferred by statute;

(f) No trade barriers. If import protection is deemed necessary, tariffs are generally preferable to quantitative controls. Rates of tariff should be as even as possible to minimize distortions;

(g) Open, competitive and lightly regulated capital markets, including an inward investment regime that welcomes foreign capital;

(h) A labour market where there is complete freedom to contract between employer and employee (and freedom to form associations voluntarily);

(i) Most important of all, clear and consistent laws that participants in the economy can be confident will be upheld in the courts. Strong property rights and independent judiciary free of corruption are two vital elements of the machinery that is necessary to support markets.

153. There is no easy recipe for economic success, but the global lessons, whether from the spectacular emergence of East Asia or the radical reform of New Zealand, are the same. More important to success than anything else are the economic fundamentals - stable macroeconomic management, investment in people, open markets and allowing prices to reflect economic scarcity.

154. For most countries, realizing such a template of policies would require a substantial adjustment in how the Government sees itself - from Government as controller to Government as the setter of the framework within which markets can operate, but the lesson from New Zealand and other countries is that such a transition is possible, and that the economic and social benefits abundantly repay any transition costs. All that is required is the political will.

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RETHINKING THE STATE FOR SOCIAL DEVELOPMENT

Report prepared by the Secretariat*

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I. AN END OF CENTURY MARKED BY DISTURBING SOCIAL TRENDS

1. Mankind is approaching the end of the twentieth century with vastly increased scientific, technological and productive capacities. Simultaneous breakthroughs are occurring in numerous branches of knowledge, giving rise to new conceptual models for interpreting phenomena and a new wave of technologies based on a knowledge of infinite possibilities. Advances in such fields as telecommunications, microelectronics, biotechnology, the material sciences, machine tools, computer science and robotics, among others, are transforming our basic production patterns. Our potential for producing goods and services has expanded and multiplied rapidly. These changes have been accompanied by a revolution in expectations. Democratic systems under which people are able to elect their representatives are becoming more prevalent and there are widespread demands for increased participation. People expect to have a real and greater say in the decision-making process and there is a broad movement towards establishing new and more active forms of organization of civil society.

2. However, the tremendous potential of our productive capacities is not resulting in improvements in the difficult conditions under which large sectors of the world's population currently live. There is a huge gap between that potential and the realities of daily life. There is also a gap between the progress made towards democracy, towards the democratic citizenship that offers people the potential for participation, and the situation of social exclusion and degraded social citizenship that many of these same people face and that creates numerous barriers to meaningful participation. The social situation to which the historic World Summit for Social Development drew attention raises profound questions about the future.

3. According to World Bank data, 1.3 billion of the world's population live on less than a dollar a day and are thus in a situation of extreme poverty. Two fifths of the world's population lack adequate health services and electricity.[1] According to the United Nations Development Programme (UNDP), there has been a marked increase in the number of poor people whose income has actually declined. Between 1965 and 1980, this situation affected 200 million poor people; between 1980 and 1993, it affected 1 billion. Some 800 million people do not receive adequate food and nearly 500 million suffer from chronic malnutrition; 17 million people die each year from curable parasitic infections and diseases such as diarrhoea, malaria and tuberculosis.[2]

4. The unemployment figures which underpin these social difficulties reflect a widespread trend towards rising unemployment and a decline in the quality of the jobs available. The International Labour Organization (ILO) World employment 1995 report states that in 1995, 30 per cent of the global labour force was either unemployed or underemployed. This phenomenon of high unemployment rates is accompanied by a steady shift towards the so-called informal economy. Although heterogeneous, in general, the informal economy tends to consist of unstable employment offering no definite prospects, no social protection of any kind, low incomes, and productivity levels which are far lower than those in the formal economy because of resource, technology and credit limitations. In Latin America, for example, informal employment accounted for 40.2 per cent of the non-agricultural employed labour force in 1980. By 1995, the proportion had

increased to 55.7 per cent. The rate of open unemployment in the region was estimated at 16.2 per cent in 1996.[3] Data on the extent of unemployment must be taken together with indicators of the average duration of unemployment. As Robert Solow has noted, the length of unemployment, which also seems to be increasing, is very important. His analyses point to the high social cost of extended periods of unemployment and show that the experience of prolonged unemployment has many adverse effects on personality which are overlooked by conventional economic studies. Prolonged unemployment leads to, among other things, apathy, a serious loss of interest in socializing and a gradual withdrawal from the labour force.[4] Loss of self-esteem is a defining element.

5. Global poverty continues to affect mainly women and children. According to ILO data, women account for a disproportionately large number of the poor, the unemployed and the underemployed. Children are highly vulnerable to the effects of poverty and there is a noticeable gap between the advances made in modern medical technology and the rates of infant mortality in poor areas. A third of children in developing countries suffer from malnutrition. The infant mortality rate for children under five in these countries is 97 per thousand, almost six times greater than the rate in developed countries. According to data provided by the United Nations Children's Fund (UNICEF), 600,000 children die each year in Latin America and the Caribbean from preventable causes.[5] Forced by circumstances, children account for a growing proportion of the labour force in various countries and work under deplorable conditions of exploitation. The problem of street children has become more widespread in many cities and poor children have become a target of choice for drug traffickers.

6. The severe social tensions that have built up in all the areas discussed, and in others which have not been mentioned, provide a fertile breeding ground for processes that weaken the social fabric. These include the breakdown of the family and rising criminality. The institution of the family, which is central to most societies and the provider of moral standards, basic education, preventive health care, nurturing and role models, is being seriously undermined by social problems and is losing its male figures. At the same time, a marked increase in crime rates is being observed in some societies. The Economist magazine, for example, reports that almost all cities in Latin America are less safe today than they were 10 years ago.[6]

7. Together, the deficiencies described above are creating vicious circles of poverty. Nutritional deficiencies in early childhood, the absence of a stable family setting, limitations on attending and remaining in school, and marginalization from the labour market give rise to a situation of social exclusion which is self-perpetuating.

8. In the closest linkage with poverty and social exclusion, a marked increase in inequity and social polarization can be observed at the international level. UNDP figures show that over the past 30 years the income of the poorest 20 per cent of the world's people declined from 2 per cent to 1.45 per cent of global income, while the share of the richest 20 per cent rose from 70 per cent to 85 per cent of global wealth. The social gap doubled in size between 1960 and 1990. At the two extremes of this global income polarization, the assets of the world's 358 billionaires exceed the combined annual incomes of countries

with 45 per cent of the world's population - 2.3 billion people. In turn, inequalities in income and in ownership of assets result in glaring inequities in access to credit and have numerous repercussions in such crucial areas as access to and continuation in educational systems, the quality of the education received by poor people and the latter's potential for academic achievement.

9. These existing inequities are being compounded by the boom in communications, which has reached a peak with the development of computer networks offering massive potential for the dissemination and exchange of information. Broad sectors of the population may have no access to these developments, however, owing to the gaps that exist in other areas. Martin Hopenhayn speaks of the threat of the emergence of new forms of computer illiteracy for those who have no access to any form of information technology.

10. In drawing the world's attention to the gravity of the problem of inequity, the UNDP Administrator told the World Summit in Copenhagen that it was crucial that the problem be tackled in the coming decades. Likewise, the President of the World Bank has said that distributing the benefits of growth is one of the greatest challenges for global stability. Social injustice may destroy economic and political progress and we must learn more about the why and the how of income distribution.' Robert Solow points out that, in order to secure the population's commitment to development policies, there must be a perception of justice by all social groups, in the sense that each group must feel that it is receiving a fair share of the fruits of economic progress.' Acute poverty and extreme social polarization create a scenario which severely jeopardizes prospects for sustained economic growth and seriously affects democratic governance in the developing countries. Lack of progress in improving the precarious quality of daily life among broad sectors of the population leads to a significant loss of credibility on the part of democratic Governments, thereby diminishing their prospect for good governance.

11. How does one deal with this disturbing social situation? Is poverty inevitable, a kind of condition of nature? In many parts of the world, this is clearly not the case, since poverty exists alongside an abundance of mineral and agricultural wealth, energy sources and strategic raw materials. Is poverty an individual condition attributable to certain people's shortcomings? There is no empirical evidence to support this kind of reasoning either. A core document submitted to the World Summit in Copenhagen by a commission of eminent persons chaired by the former President of Chile, Patricio Aylwin, pointed out that, generally speaking, the poor are not responsible for their situation. Many of them are hard-working individuals who manage to overcome their poverty when they are given a little help or when the country's overall situation improves.

12. In view of the persistence and the exacerbation of the problem, new solutions are being sought and new lines of research and study are being pursued in this area, leading in turn to a radical rethinking of the role and structure of the State. We shall now examine these new directions in the debate, while later in our analysis we shall use them to discuss what role the State should play in the social sphere in the developing world. Having identified this role, we shall reflect on guidelines for redesigning institutions and the State in line with that role and on what kind of management would be best suited to ensuring that the State performs effectively in the social sphere, and we shall

conclude with a final note. In any event, the analysis will be exploratory and its main purpose will be to draw attention to the need to inject new ideas into the agenda for the discussion of these issues.

II. NEW DIRECTIONS IN THE DEBATE ON SOCIAL DEVELOPMENT

13. Shahid Javed Burki, a Vice-President of the World Bank, recently pointed out that the situation of the poorest 20 per cent of the world's population is not improving and that this is particularly true of two regions: Latin America and Africa.[11] The persistence and aggravation of social problems and the widespread demands for their solution, emanating principally from the World Summit for Social Development, have sparked a broad debate which is taking a fresh look at most of the basic premises of social action in recent decades. The new debate which arose from a feeling of powerlessness at the lack of answers and the limited results of models which, on paper, were supposed to provide effective solutions is challenging basic aspects of their validity and seeking alternative analytical models which might be more useful. Some of the basic elements being explored in a debate which now involves Governments, academic institutions, members of civil society, international cooperation and funding agencies and world public opinion are summarized below.

A. Questioning the "trickle-down" model

14. In recent decades, a number of popular approaches have offered an answer based essentially on "trickle-down" theory. The well-known basic assumptions of this theory are that making huge sacrifices in order to attain macroeconomic goals which involve economic and financial equilibria will bring about economic progress, and that this will ultimately "trickle down" to the entire population, including the poorest groups, lifting them out of their situation of dire poverty. There would be a difficult waiting period before this phase of delays and almost enforced accumulation finally produced a happy ending. As has happened so many times in the past, the facts on the ground have not matched the assumptions of the model. The road to development seems to be infinitely more complex according to, among others, the comprehensive research of the UNDP Human Development Reports, which cover almost all the developing countries and give a complete account of recent decades. The facts indicate that reality operates very differently from those assumptions. The evidence shows that, while it is essential for a country to achieve economic stability and financial equilibria and to increase its competitiveness and gross national product, this does not automatically "trickle down". On the contrary, it is perfectly possible for indicators to improve, while the situation of the most disadvantaged sectors continues to deteriorate or remains static. According to the World Bank Annual Report 1995, "Improving income distribution and alleviating poverty cannot be left to trickle down consequences of economic growth". The World Bank also maintains, in an analysis of the causes of the Mexican economic crisis, that "for many years, acceleration in growth was considered the main prescription for reducing inequalities and poverty. Increasingly, however, empirical evidence indicates that, although very important, higher growth is not enough".[12] In its Human Development Report 1996, UNDP warns that attention must be focused on the structure and quality of growth, since even when there is growth, it may be

accompanied by unemployment, marginalization, lack of participation, a weakening of national cultures or environmental degradation, rendering it "futureless".

15. The increasingly widespread perception of the inefficiency of the trickle-down model points to the fact that the relationship between the economic and social spheres is far more complex than the model assumed and that, like other models in the past, it has been demolished by the facts, making it necessary to find new approaches.

B. Revaluation of human and social capital

16. To a large extent, research and debate are engaged in an in-depth reassessment of the impact on development of forms of capital accumulation, which until now, have not been adequately evaluated. In addition to "traditional" capital - the natural capital of a society, consisting of its natural resources, and its man-made capital, consisting of what it has produced (infrastructure, business capital, financial capital, etc.) - a closer look should be taken at two other forms of capital: human capital and social capital. The first has to do with the quality of human resources, the second, with qualitative elements such as shared values, culture, the capacity to act synergetically and to generate networks and the level of consultation and dialogue within the society. In an analysis of the factors contributing to economic growth, a World Bank study on 192 countries concluded that no less than 64 per cent of growth can be attributed to human capital and social capital.[13]

17. Human capital formation involves systematic, ongoing investment in such areas as education, health and nutrition. As we approach the end of the century, education has become one of the most cost-effective investments. This has to do with the radical changes that are occurring in production structures, which are tending to emphasize knowledge as a building block of the new productive matrices. Pure knowledge is now the basis of high technology industries, and there is every indication that this trend will continue. Lester Thurow maintains that the twenty-first century will be a century of "brainpower" and that knowledge has become the only source of long-run sustainable competitive advantage.[14] Among other things, computers use virtually no natural resources and are based on knowledge. Accordingly, he says that the "rate of return for industries that invest in knowledge and skill today will [be] more than twice that of those that concentrate on plant and equipment". Robert Reich, former United States Secretary of Labour emphasizes the decisive impact of education, noting that the winners in this new globalized, volatile economy are those who can identify and resolve problems, handle and analyse symbols and create and manage information. He recommends that his own country, the United States of America, should invest in the education and training of its people by providing good public schools and excellent public universities and that they should be public in the truest sense of the word: accessible to all, supported by all.[15] Jacques Delors highlights the vital historical role of education in our time: "human progress is largely dependent on it. ... The idea is gaining ground that education is one of the most powerful tools with which to shape the future".[16] The education, science and technology budgets of economically and technologically advanced countries have increased dramatically. Japan has just approved a 50 per cent increase over its already high science and

technology budget of the past five years. In the next five-year period it will be $155 million. Government funding for science and technology in the year 2000 should be twice that in 1992. In the Republic of Korea, investment in education amounts to 10 per cent of the gross national product, well above that of the developing world. Since 1994, Israel has been carrying out a further reform of its already advanced educational system, which has meant a 33 per cent increase in real terms in the resources allocated to education. This will make it possible, inter alia, to bring teachers in all schools up to date with the latest advances in computer technology and to introduce those advances in all classrooms. High-technology private firms have significantly increased their staff training budgets, which in some cases now amount to nearly 10 per cent of total payroll.

18. Health spending, which is a cornerstone of human capital development, has proved extremely cost-effective. Activities promoted by the World Health Organization, the Pan-American Sanitary Bureau and UNICEF, for example, in the area of high-mortality diseases such as infant diarrhoea and cholera, have had a major impact in a short time with minimal investments. Combined efforts in the fields of health and education have tremendous potential. Expanding and improving education for girls from deprived areas is considered to be one of the most profitable end-of-century investments. According to World Bank estimates, providing three more years of basic schooling for these girls would reduce the infant mortality rate by 15 per thousand. These additional years would increase the girls' educational capital, enabling them to deal much more effectively with issues such as teenage pregnancy, family planning, prenatal care, neonatal care and nutrition management.

19. Social capital can, in turn, generate very high returns for economic progress and general well-being. The much-publicized study by Robert Putnam empirically confirms its strategic contribution to growth.[11] The author says that it is a public good: "one special feature of social capital, like trust, norms and networks, is that it is ordinarily a public good, unlike conventional capital, which is ordinarily a private good". A biased evaluation process occurs: "like all public goods, social capital tends to be undervalued and undersupplied by private agents". Underestimating it is a mistake, for such capital can have a decisive impact. Analysing the Italian experience, Putnam emphasizes the key role of social capital, identifying some of its practical effects: "in the civic regions of Italy, by contrast to Naples, social trust has long been a key ingredient in the ethos that has sustained economic dynamism and government performance. Cooperation is often required - between legislature and executive, between workers and managers, among political parties, between the government and private groups, among small firms and so on. Yet explicit "contracting" and "monitoring" in such cases is often costly or impossible, and third-party enforcement is impractical. Trust lubricates cooperation. The greater the level of trust within a community, the greater the likelihood of cooperation. And cooperation itself breeds trust. The steady accumulation of social capital is a crucial part of the story behind the virtuous circles of civic Italy".

20. Human capital and social capital have been rediscovered in recent years, and development cannot be seriously considered without taking into account their significant impact as its "levers".

C. Rethinking the concept of equity

21. Here again, the conventional models have clashed with historical facts, and their failure has generated broad new possibilities for research on the topic and for designing new models and testing new responses.

22. As Nancy Birdsall, David Rose and Richard Sabot have noted, the assumption that there is an inverse relationship between an increase in growth and a reduction in inequality has been a basic postulate of conventional economic theories about the nature of the development process.* For these theories to work, a high degree of inequity would be necessary in order to obtain cumulative benefits and promote growth. However, a rigorous econometric analysis of the experience of two regions of the world - South-East Asia and Latin America - in the past 30 years shows just the opposite. Birdsall, Ross and Sabot speculate as to why relatively low economic growth rates and a high degree of inequality are found in Latin America, compared to rapid growth and a low degree of inequality in East Asia. While in the countries of South-East Asia the active effort to reduce inequality has lowered its levels significantly, and in the Republic of Korea the distribution of national income between the top 20 per cent and the bottom 20 per cent is now 8 to 1, the situation in Latin America has become more polarized, with a gap of 26 to 1 in Brazil and growing disparities in Mexico and Argentina and the region in general. Among other things, vicious or virtuous circles can be seen - depending on whether equity is increasing or decreasing - between equity, education and growth. The above-mentioned study found that in the 1950s the rate of completion of primary school in Brazil was 60 per cent, much higher than that of the Republic of Korea, which was 35 per cent. In the three decades that followed, while inequity grew in Brazil, it decreased significantly in the Republic of Korea. This and other factors determined that the rate of primary school completion in Brazil dropped considerably, while in the Republic of Korea it rose to over 90 per cent. According to The Economist, the evolution of inequality in Brazil was of the following type:

Table 1

INCOME DISTRIBUTION: BRAZIL

	Percentage of national income	
	1970	1994
Richest 1% of population	8	15
Poorest 25% of population	16	12

Source: The Economist, 29 April 1995.

23. The application of the Gini coefficient, which measures degrees of inequality in income distribution in Latin America, Africa, South-East Asia and East Asia shows how the coefficient, which rises when inequality increases, reflects appreciable positive differences in the last-mentioned two regions, which in turn have grown at a faster and more sustained rate than the others.

Table 2

DISTRIBUTION OF NATIONAL INCOME

(in percentages)

Population	South-East Asia, East Asia	Africa	Latin America
Poorest quintile	8.1, 6.6	6.0	3.3
2nd quintile	12.2, 11.4	8.2	7.2
3rd quintile	16.1, 16.6	11.5	11.9
4th quintile	21.8, 24.9	18.5	19.8
Richest quintile	42.0, 40.4	55.9	57.9
Gini coefficient	0.31, 0.32	0.44	0.49

Quintiles follow increasing order of income.

Source: Weaver, J. and Sprout, R. in Michael Rock, "Twenty-five years of economic development revisited", World Development, vol. 21, No. 11, 1993.

24. Actual data have definitively disproved the idea that inequity is ultimately a function of economic growth. The situation, as described by Joseph Stiglitz, is as follows:

> "There are positive relations between growth and equality. High rates of growth provided resources that could be used to promote equality, just as the high degree of equality helped sustain the high rates of growth. Although this may seem to be little more than common sense, until the experience of East Asia, 'common sense' suggested quite the contrary: growth produced inequality, and inequality was necessary for growth."[19]

25. With the collapse of the "common sense" approach taken by conventional economic theory, the entire field is now open for reinvestigation. There is a

pressing need for this research, in view of the aforementioned high levels of inequality today, which augur severe problems for future growth and in themselves generate widespread social tensions within societies. The many new approaches to research at the international level are systematically beginning to detect various orders of inequality. Together with inequity in incomes, these studies are exploring, among other things, inequality in the possession of assets and inequities in access to credit, both of which are highly significant in economic terms. A recent study by Deininger and Squire found that an inequitable distribution of land - a crucial asset - has a clearly negative effect on subsequent growth. According to this study, only 2 out of 15 countries with Gini coefficients for land distribution greater than 70 had a growth rate that was higher than the low level of 2.5 per cent in the period 1960-1992.[20] Hongyi, Squire and Zou, in another study, show that the initial inequity in the distribution of assets may be maintained indefinitely, generation after generation, with regressive consequences, and that effective policies are required in order to reduce it.[21]

D. Interrelationship between economic development and social development

26. The discrediting of the trickle-down theory, the revaluation of human and social capital and the re-examination of relationships between inequity and growth are prime dimensions in a broader debate involving the global orientation of development models. On the one hand, it is evident that relations between economic and social matters are complex. The trickle-down mechanism assumed that, given enough time, the benefits of growth would reach the poorer sectors. The real process is different. Moreover, some researchers are going even further, suggesting that the entire process should not be thought of in terms of resolving one dimension at the expense of others, but that there is a basic interrelationship between them. Practical experience seems to indicate that social development is vital to the prospects for sustained economic growth. Investments in human and social capital and improvement of equity, besides being ends in themselves from the standpoint of democratic societies, are necessary in order to provide a solid foundation for economic growth. Thus, as James Wolfensohn has suggested, without parallel social development there can be no satisfactory economic development.[22] IDB notes with respect to the case of Latin America that the persistent social gaps in the accumulation of human capital have augmented the large proportion of persons living in poverty and the highly unequal distribution of wealth in the region. These social gaps continue to limit productivity and economic growth in the region and delay the democratization and modernization of States.[23]

27. The current view is that there is a gap to be closed in both directions, without which development itself is highly vulnerable. There is no way to support social development without economic growth, monetary stability and economic and financial equilibria, but in turn these will not be sustainable in the medium and long term if an active social development does not occur. This view opens up the possibility for alternative policies to "conventional common sense", which are now beginning to take shape. Thus, Amartya Sen suggests that, on the one hand, there are approaches that see development as a "cruel" process, based on a morality which suggests "blood, sweat and tears". The rhetoric of

these approaches is that sacrifices are needed to ensure a better future - sacrifices linked, for example, to a low level of welfare, great inequality, authoritarianism, etc.[24] This approach, according to Sen, has been heavily oversold. It does not seem to lead to the results promised by past experience and generates very high levels of tension. It is often presented as the only alternative. The inclusion of the above-mentioned new elements in the debate offers a broad possibility for designing other alternatives. Sen speaks of perspectives which see development as an essentially amicable process centred on helping others and oneself, and with the possibility of moving ahead with a little help from one's friends. This "little help" may come from interdependence in the marketplace (mutual trade benefits) but also from public services which provide people with more training sc that they can help themselves and others. Experience in the past few decades shows that, in response to the traditional separation between economic and social affairs, where, as is increasingly being pointed out, social policies are ultimately dedicated to "picking up the dead and wounded left by economic policy", an integral link could be postulated between the two which would thoroughly exploit their complementarities. The societies that have managed to combine the two types of development are among the most advanced in the world, and show by their example that such integration is feasible. Thus, countries such as Canada, Norway, Sweden, Denmark, the Netherlands, Belgium, Japan, Israel and the countries of South-East Asia are in the forefront with respect to successful macroeconomic results and human development indicators.

28. The new directions in the debate on social development require, in turn, a re-examination of the conventional wisdom of recent decades concerning the role of the State. What new roles are to be expected in view of the profound re-examination currently under way in the framework of global concepts of development?

III. RETHINKING THE ROLE OF THE STATE

29. The usual approach to the issue of how to redesign the State to facilitate and promote social development is to work directly on its organizational structures, enhance the efficiency of its management and incorporate modernizing techniques. Although these aspects are essential, they cannot be addressed until a decision has been reached on what role the State should play in developing countries at the close of this century. The types of technical change and modernization which are considered absolutely necessary cannot be selected in the abstract or on the basis of the supply of technologies on the market. There must be selection criteria guided by a central idea of what, in the light of the specific role to be played by the State, would be the "technological style" most likely to enable the State to play that role most effectively. Purely technocratic discussions on State reform for social development should give way to a broader debate which, beginning with a reassessment of development models, draws conclusions as to what the roles of a "desirable State" should be and, on that basis, develops technical criteria for equipping the State to carry out those roles. The type of methodological approach suggested is the one which we are attempting to put forward in this study.[25]

30. The discussion on the role of the State in the social sphere is part of a larger debate on the overall role of the State. Generally speaking, and as has often been pointed out, the pendulum has swung sharply. A few decades ago, it focused on the idea that it was possible to conceive of a State that would comprehensively plan all aspects of development and implement those plans through its own machinery, carrying out those operations from the centralized level and assuming all types of executory functions. In practice, this view proved to be seriously flawed, both in its conception - which underestimated or marginalized civil society in its many manifestations - and in its implementation, as major inefficiencies in the State machinery became apparent and the centralized management style turned out to be a key source of rigidity and of serious discrepancies with the exigencies of reality.

31. The pendulum then swung in the opposite direction, and the need for "State minimalism" was postulated. It was asserted that the State's functions should be kept to an absolute minimum and that development should be left to the market and the "invisible hand". The State was perceived as an obstacle to the dynamic that was to be created. Much was made of the supposed antagonism between State and market. An active process of demolishing the State was pursued in developing countries. For a long time, efforts focused on the issue of size, as continual and often not very selective cuts were made to reduce it. Many of the State's functions were abolished. In several cases, attempts were made to privatize and to eliminate functions as quickly as possible, even though it was acknowledged that the operations concerned could have been carried out more efficiently for the country's sake and that the public regulatory capacities which supposedly would be needed for the next phase were very weak or nearly non-existent. Moreover, like the first approach, this approach implicitly underestimates the productive and contributory capacities of other expressions of civil society which are neither the State nor the market, such as the very broad spectrum of structures created by the community to carry out essential functions.

32. History has shown that neither extreme led to the desired solutions. Rudiger Dornbusch notes, with reference to the American experience, that the United States is a step ahead, having seen that excessive competition, heedless deregulation and a lack of State intervention have carried things too far. As the pendulum swings the other way, the re-emergence of the State can already be predicted. In 10 years' time, the United States will be able to look back on this as a period of reconstruction centred on a correct conception of the State, on the right kind of cooperation among the Government, the labour force and business, and on the need for the Government to play a crucial role in seeking solutions to the problems of coordinating and exploiting external factors.[25]

33. The rethinking of this whole issue is based on the clash between theoretical models and reality. The facts have seriously challenged widely held assumptions. For example, it is said that confining the issue to a discussion on the size of the State and believing that the reduction of the State will automatically provide solutions is an illusion. The data clearly show that, if the size of the State is measured, inter alia, in terms of civil servants per 100 citizens served and percentage of public expenditure in relation to gross national product (GNP), the relative size of the State in many developing countries is considerably smaller than in most developed economies. The central

issue should not be size in the abstract, but what role the State should play in the historical process and how to give it the managerial capacity it needs to play that role efficiently.

34. Reality, in turn, has shown that in the new globalized world, where the multiplication of interrelationships and the profound geopolitical, geoeconomic and technological changes which have occurred in a very short period of time have resulted in a "complexity explosion", the State must carry out functions which were not part of any of its previous roles in history. Globalization, rapid change and complexity have come with a large dose of uncertainty. Edgard Morin warns that "becoming" is not necessarily synonymous with "developing" and that, from now on, the future is uncertain. He underscores the difficulties of predicting the future, asserting that we are in the midst of not only the unknown but the unnamed, and that our understanding of these times is expressed merely in the formless prefix "post" (post-industrial, post-modern, post-structuralist, etc.) or in the negative prefix "anti" (anti-totalitarian). Thus, we have no clear picture of our future or even of our present.[27] The same feeling with respect to a society that is ever more globalized, and therefore more complex and multidimensional, is described by thinkers in the developing world, who compare it to navigating, almost without a compass and with limited and all too often outdated maps, the whirlwind of change brought about by globalization. So many changes and so few maps, they say, are one of the main sources of the uncertainty and anxiety so often seen in today's world.[28] These developments have generated widespread demands for new types of State responses. Michel Crozier notes that we need more public intervention to handle complexity and that, in one way or another, all groups - even groups of businessmen - require intervention.[29] In the developing world, the possibility of promoting and strengthening subregional and regional integration schemes, which can be so useful in the context of globalization, is generating a wave of demands for catalytic and facilitating roles that could be carried out by a State which has gained efficiency in this crucial area.

35. Together with the demands arising from globalization and complexity, there are others which are linked to the development of the State's regulatory capacities. Regulation emerges as a requirement of economic efficiency and as a deeply felt social concern in the face of the enormous price which society as a whole may have to pay if areas critically important to it are left to an "invisible hand". Lester Thurow warns, in this regard, that Adam Smith's idea that the individual search for profit always promotes the economic growth of a nation runs into problems in practice because, very often, Adam Smith's "invisible hand" becomes the hand of a pickpocket. Free and unfettered markets have a habit of discovering highly profitable but unproductive activities, and practical experience shows that maximizing profits does not always mean maximizing output.[30]

36. Other demands on the State have to do with inequity and its costs. Dornbusch notes that the market does not facilitate a socially acceptable distribution of income and that State intervention, therefore, is legitimate when it tries to equalize the distribution of the income generated by the market. In this view, equality of opportunity and, to some extent, of outcome is not only an ethical precept but also an imperative because there is growing evidence that excessive inequality leads to social conflict.[31]

37. The minimalist State, which has little managerial capacity and is nearly absent from these and other key processes of our time, is very unlikely to be able to help society cope with them adequately. When tested against reality, the underlying idea that "the best government is no government" led to the caustic assertion, by a recognized management authority, that this model "represents the great experiment of economists who have never had to manage anything".[11]

38. In contrast to the pendulum's two extremes, a different conception is currently emerging which indicates, based on recent historical evidence, that the societies which have made the most consistent progress in recent decades are those which have moved beyond the false State-versus-market dichotomy. In its place, they have developed a model of cooperation among the main social actors and have actively integrated into that model the powerful latent forces of civil society, which both extremes tended to marginalize. These models recognize that there is a wide range of organizations between the State and the market, including, inter alia, public interest groups that serve collectively useful purposes but are not part of either the State or the market; the new generation of business cooperatives that are widespread in many developed countries; non-governmental organizations; religious-based voluntary social organizations, which have grown significantly; neighbourhood organizations; environmental groups; volunteerism; and a multitude of other groupings of civil society. The aim, in the new conception, is to add the potential of the market and the multiple contributions which civil society can make to the key roles which the State can play for society, inter alia, to meet the demands noted earlier. From this standpoint, it is essential to rebuild a State which can meet new demands, work in harmony with the forces of private enterprise to achieve optimum results for the country, and promote and facilitate the development of an increasingly close-knit, strong and active civil society.

39. There is a need to rebuild the State with the aim of creating what could be called "smart government"; in other words, government that focuses on its strategic roles in society, with an institutional design and a development of managerial capacities that enable it to play them in a highly effective manner. A wealth of evidence shows that one of the key roles of "smart government" will be in the field of social development. As noted earlier, new views of development, in which the State has crucial roles to play, have emerged in response to the large-scale problems outlined in the first part of this study and the failure of trickle-down models to solve them.

40. In the trickle-down model, the view that growth would solve the problems of poverty by itself led to a minimalist and welfare-oriented conception of the State's role in the social sphere. According to that view, the State should confine itself to mitigating the temporary maladjustments that would occur as the trickle-down effect began to work. Its role should be to carry out only time-bound, targeted programmes to attenuate impacts. Limited resources should be allocated to its social activities, since such resources were being siphoned off from the central policy of growth and trickle-down that would generate the real solutions. These guidelines resulted in a strong movement towards "disarming" the State in the social field by dismantling services, causing a de facto brain drain from the public sector to the private sector and creating a great deal of uncertainty for agencies operating in the social sector by making

them increasingly dependent on external decisions taken with little input from them. The new directions of the debate show that this type of forced, narrow restructuring of the State in the social sphere actually aggravated the problems. Investment in human capital and social capital declined, the already high levels of inequity increased and the possibility of integrating economic and social policies became even more remote. The new orientations of the social development debate suggest a very different role for the State.

41. To build human capital, a society needs a systematic, long-term policy to that effect, in which the State plays a key role. To develop social capital, the State must protect it and actively promote synergies. Improvement of equity calls for active State efforts in that direction. A World Bank study emphasizes that State actions which result in a more equitable distribution of wealth could well become an integral part of a successful economic strategy.[33] The interrelationship established between the economic and social spheres in a development model that mobilizes the complementarities of both requires the State to play a coordinating and synergetic role. Job creation and suitable income policies must be at the heart of this interrelationship. A fundamental aspect of the new role is to enlist allies in the effort to tackle social problems. The State must generate initiatives that promote active participation in this effort by basic social actors, private enterprise, trade unions, universities and civil society in all its manifestations.

42. Smart government in the social sphere is not a minimalist or absent Government that carries out short-term welfare-based actions, but rather one with a State policy (as opposed to a party policy) on education, health, nutrition and culture which is oriented towards overcoming gross inequities and promoting cooperation between the economic and social fields, while enhancing the contribution of civil society through an ongoing synergetic role. This time, it is not a question of postulating yet another theoretical model. Rather, this type of thinking about the State is emerging forcefully from the historical experience of the past few decades, which shows that countries where the State has taken on roles of this type have achieved very significant results. Amartya Sen describes the recent world historical context by stressing that many Western European countries have managed to ensure widespread social security coverage, with the provision of public health care and education in ways hitherto unheard of anywhere in the world; Japan and East Asia have seen a high level of government leadership in the transformation of both their economies and their societies; the role of public education and health care has been the linchpin of efforts towards social and economic change throughout the world (and quite spectacularly in East and South-East Asia); and pragmatic policy-making has drawn inspiration from both the market and the State, and even from institutions which belong to neither category, such as community organizations.[34]

43. Nancy Birdsall emphasizes the role played by the Japanese Government in promoting small- and medium-scale enterprise, in the context of a "bottom-up" growth strategy to generate jobs. She notes that Japan's Ministry of International Trade and Industry considered the lack of modernization of small business as a potential stumbling block to growth, and that the Japanese Government's support for small businesses was one of the most lasting and constant aspects of industrial policy.[35]

44. In democratic Chile, the Government-elect totally replaced the social strategy of the previous administration. Although the latter had scored economic successes, the social situation had palpably worsened, as the estimated proportion of families living below the poverty line rose from 20 to 40 per cent of the population. The democratic Government gave high priority to social issues and launched a proactive social policy based on four guiding principles: equity, solidarity, integration and social participation. It cooperated extensively with the private sector to improve social conditions and strongly encouraged civil society to act. The results of this effort, which has sought to build an ongoing interrelationship between social and economic issues, have been impressive, and progress in both areas has been mutually strengthened.

45. In these and other cases, a State which is active in the social field, aware of the impact of globalization and the market on social problems, aggressive in developing human capital and social capital, involved in forging continual strategic alliances among the various social actors to promote poverty reduction, and placed fully at the service of society is emerging as a key historical tool for societies.

46. Some of the basic risks entailed in insisting on ideas such as State minimalism or in allowing the State to be guided by the interests of internal bureaucracies are vividly demonstrated by Paul Streeten. He suggests that the most serious problems arise not from market failure but from market success, and not from the failure of certain government bureaucracies but from the opposite. He notes that "if the signals propagated by the market are based on a very unequal distribution of land, other assets, and income, it is market success in responding to these signals that causes the trouble". He notes further that "Amartya Sen has analyzed famines and shown that often total food supply was adequate, but that the purchasing power ... of a particular group of poor people had declined. In those conditions the market is all too successful in its signals, incentives and allocations, while people starve". Similarly, he indicates that it is government success in pursuing the self-interested objectives of its officials that produces the destructive results which have been widely deplored.[36]

47. In view of what have been described as desirable roles, how can the State be equipped with the institutional and managerial capacity to play them? What would be the profile of "smart government" in the social field?

IV. COURSES OF ACTION FOR REDESIGNING THE STATE IN THE SOCIAL SPHERE

48. In the developing world, major State reforms have been carried out in the social sphere in the context of macroeconomic adjustment processes. The basic profile of these reforms has been described by Fernando Zumbado and the characteristics can be applied to many countries: up to now, social reform has been a product of the exigencies of stabilization programmes and structural adjustment. In this respect, unfortunately, the reduction of public social spending and the dismantling of inefficient services have played a decisive role in the growth of poverty. It has taken a long time to produce alternative, more effective programmes.[37]

49. From these reforms a post-adjustment State has emerged, which seems to have serious institutional and managerial limitations and weaknesses that hamper it in performing roles such as those outlined in the previous section. The State needs to be reconstructed in the social sphere so that the roles in question can be performed effectively. This reconstruction cannot be backward-looking. Such a course would not be advisable, considering the major operational shortcomings, rigidities and incapacities of State social structures in previous decades. However, mere cuts are not the reform which is required either. Zumbado's call is fully justified: alternative, more effective, programmes are needed.

50. The rebuilding of State management capacity for active, equitable and sustained social development must be carried out in a forward-looking manner. The State must be connected in the social sphere with the new technological frontiers in management and institutional development. In recent decades, there have been fundamental changes in the basic ideas as to how to achieve greater organizational efficiency. At the global level, a new managerial paradigm is emerging with analytical models, hypotheses and technical proposals which are very different from those which predominated for much of this century.[14] A transition from administration to management is under way. The most efficient organizations of our time have generated many elements of this emerging paradigm in their practice, and they are operating increasingly on its basis. It is an important source of reference on how to manage organizations in the year 2000, which may be of great value for the reform of the State in the social sphere. The challenge is how to accommodate the special problems and characteristics of State social sectors in the latest developments in organizational management at the global level. This process does not consist of copying management methods which are in vogue; the challenge is much broader and more complex. It is a matter of seeing whether it is possible to re-examine social management problems on the basis of recent innovations in the understanding of organizational behaviour, while fully respecting their unique and specific characteristics. This re-examination would be the starting point for designing, on its basis, appropriate technical solutions for the State in the social sphere. What is being proposed then is not a process of mechanical appropriation of fashionable managerial solutions, but a vast research and development effort to generate organizational innovation in the social areas.

51. The forward-looking reconstruction of the State in the social sphere therefore entails tackling basic questions such as the following:

(a) What are the truly strategic problems that hinder efficiency? The traditional approach stressed problems of an essentially formal nature connected with organizational charts, procedures, operating manuals, norms and circuits. In the latest management theory, it is felt that this area should be improved, but that the effects of these improvements on final organizational output are very limited. Final output depends on other much more strategic aspects.

(b) How can these problems be tackled in the light of advances in management science while taking into account the very specific characteristics of the management of social programmes?

(c) How can solutions be found that will ultimately ensure that, in the developing countries, the State effectively fulfils the roles assigned to it in

the social sphere, including a drastic improvement in education and health care, the development of social capital, the achievement of greater equity, the optimum use of scarce resources, the production of sustainable solutions, the active promotion of participation by civil society in all its manifestations in social undertakings and the development of the internal capacities of disadvantaged communities?

52. Starting from these conceptual foundations, some courses of action will now be suggested which are considered crucial for redesigning the State in the social sphere. They should be regarded as courses of action whereby gradual changes would be made with a view to achieving the goals pursued. The approach suggested basically constitutes a selective and gradual strategy for change.

A. Reorganization of social policy

53. In the State structures of the developing world, social policy has operated as an area which lacks autonomy in relation to variables which are critical to the achievement of its objectives. Aspects essential to its proper operation have been determined from the outside. Normally, the economic policy areas of States take substantive decisions on issues of great social impact and simply communicate them to the social areas. The latter have very limited organizational participation in the relevant decision-making processes. Social operators have very little involvement in crucial decisions on issues such as credit policy, negotiation of the external debt, tariff policies and fiscal policy which will have a far-reaching impact in the social sphere. Furthermore, the information used in the respective decision-making processes is almost entirely generated by the economic areas; very few information inputs provided by the social areas are used. The organizational position of the social areas in the government power structure also shows marked weaknesses. Regardless of formal titles, their frequency of access to the head of State and their involvement in critical decision-making spheres are considerably more limited than those of the economic and political areas.

54. Under these circumstances, social policy is carried out in a context of subordination and isolation. Control of the level of uncertainty, a key factor of organizational power, is very low. The basic parameters of social policy can easily be manipulated from outside, leaving no place for carefully thought-out schemes.

55. This structural and organizational weakness of the social policy area is consistent with a vision of development in which social development is perceived as a "residual" by-product of other policies. If this vision is thoroughly revised and it is recognized, as mentioned, that the levers of development are many, that there are social dimensions that are crucial if development is to be sustainable and that the "residue" can obstruct the entire process, then it becomes apparent that there is a strong need to restructure the traditional organizational pattern. As Enrique Iglesias rightly observes, the State is the main agent responsible for ensuring the great compromise between economic and social policy.[39] Ensuring such a compromise means redefining organizational responsibilities in such a way as to encourage it. This is a highly complex issue. It cannot be resolved by establishing sporadic coordination mechanisms,

such as steering committees in which the respective senior ministers meet every so often. That is a useful step, but it represents a primary level of coordination. In order to move towards a joint formulation of economic and social policies, much more sophisticated levels are required. Coordination must encompass the various stages of the formulation of public policies. Among other things, it means creating databases on social development, far bigger and better than those currently in existence, which can be a crucial frame of reference in the design of policies. It means giving the social areas direct access to the setting of agendas for discussion. It means setting up organizational mechanisms to enable the joint formulation of decisions at crucial levels, so that, together with economic variables, social variables are incorporated fully into frameworks for decision-making. It means setting up monitoring systems in real time which provide ongoing information on the social impact of economic policies and feedback on the implementation of joint designs. It is necessary to establish an institutional framework that facilitates increasing levels of coordination, in line with what, in some countries that are more advanced in this area, is called generating a "social economy", that is to say, integrated, and not merely coordinated, economic and social policy designs. There are various experiences along these lines which indicate the feasibility of such a project. For example, the democratic Government of Chile has developed an active, ongoing practice of close coordination between economic and social policies. In Israel, a system for monitoring the social situation was developed which generates data that are used jointly by decision makers at the economic, social and parliamentary levels.

56. In addition to tighter coordination, what is needed is a reclassification of the social areas in terms of their importance and hence their access to the basic centres of power.

B. Need for a radical improvement in intragovernmental coordination in the social sphere

57. The coordination problems affecting the social areas of central governments do not arise solely at the external level; in the developing world, such agencies tend to have very low levels of internal coordination. The ministries in charge of such social policies as education, health, family welfare, housing, social development, and so on, tend to act in isolation and in a highly uncoordinated manner. For their part, the various public agencies operating in the social sphere have weak real links to the relevant ministries and limited relationships with one another. Social investment funds, a significant institutional effort of recent decades, have received only limited acceptance from the government social area and operate with this severe restriction. In fact, not only are there huge gaps in coordination, but also frequent sharp conflicts over jurisdiction, resources and programmes.

58. All of this has an important impact on the final outcome, since social policy is, by its very nature, an area in which no institutional agent can achieve fundamental goals on its own. Thus, the goals to be achieved with regard to educational deficiencies require firm support from the health care and nutrition systems. Progress in health care requires active cooperation with the educational system. The transformation of urban areas with marginal dwellings

into stable and productive settlements requires the combined efforts of various social agencies. Optimum results in the social sphere can be obtained only when there is operational integration of the various areas.

59. Behind the serious difficulties of inter-agency coordination lie various problems which should be brought into focus. Some of these are of a conceptual nature. Many government bureaucracies have developed on the basis of markedly sectoral approaches. The organizational design has tended to create a strict separation among sectors, to establish rigid boundaries and totally distinct responsibilities, and to institutionalize a highly formalized division of labour. The realities of programmes to alleviate urban poverty or promote rural development require a different kind of organizational design which facilitates overlapping approaches, teamwork in the field and joint optimization of scarce available resources. Instead of continuing to sectoralize the social policy area, what is needed is to "inter-institutionalize" it, in other words, to increase the real links among the various agents involved.

60. Other problems are very concrete: conflicts of interest, power struggles, territorial disputes. Such problems cannot be solved through traditional approaches which set up formal coordinating structures. These structures establish on paper various kinds of units in which coordination is supposed to take place, but they are usually of limited effectiveness. The serious problems affecting the functioning of social policy steering committees are an illustration of this. These committees bring together the senior ministers in charge of social policies and the heads of government social agencies. In theory, they are a useful tool; in reality, however, their productivity is generally low. Their agendas tend to exclude controversial issues and to concentrate on minor aspects of administrative coordination. The technical arrangements for following up the decisions adopted are limited. Meetings are not supported by systematic technical preparation in advance. The formal approach should be replaced by a substantive approach. Participants should begin by recognizing that there are real underlying conflicts and attempt to address them. A good many of these conflicts could probably be resolved if the parties engaged in organic negotiating processes using advanced technical models. In the first place, negotiations would enable them to identify points of agreement, recognize the benefits to all of carrying out joint efforts, and design common programmes on that basis. Current experience in this area shows that ministries and agencies can easily derive benefits from joint work in such areas as, for example, the production of high-quality social data for shared use, the pooled training of human resources skilled in critical areas, and a common position in negotiations on relevant issues with the economic agencies. While such an approach would not resolve all conflicts, it would reduce and limit them. In addition, organizational mechanisms should be set up to facilitate effective coordination. The meetings of social policy steering committees should be preceded by a consultation process broad enough to enable representative agendas to be drawn up. Likewise, systems should be put in place for monitoring the results of the implementation of the decisions adopted, thereby providing feedback for the adoption of decisions by the steering committees.

61. All these efforts must be made in the context of an in-depth conceptual discussion which will heighten awareness of the need to abandon sectoral

approaches, given that the very nature of social problems calls for a combined approach.

C. Decentralization as an opportunity

62. One of the main opportunities for making positive changes in the State social sphere in developing countries is provided by the decentralization of social services to regions and municipalities. Such decentralization offers numerous advantages. From the standpoint of effectiveness, social programmes can be matched much more closely to the real needs of the target population. From a strictly managerial standpoint, decentralization will heighten efficiency by offering greater opportunities for a dynamic, flexible and rapid response. With regard to the medium- and long-term sustainability of programmes, decentralization encourages recipient populations to articulate their needs, and this will help to make efforts self-sustaining. Lastly, decentralization contributes to the process of putting in place integrated economic and social policies at the regional level.

63. Many countries are implementing decentralization processes in the social sphere which are clearly forward-looking. Efforts are being made to decentralize areas such as primary and secondary education, primary health care and hospital services, housing, environmental sanitation, water pipelines, sewers, drainage and solid waste disposal systems, nutrition, social security, transportation and culture, among others. However, close attention must be paid to past experience in order to be aware of the difficulties and risks that may arise and to devise strategies for tackling and resolving them.

64. Other problems include the degree of institutional clarity of the decentralization process. In some cases, the respective roles of the central Government, regions and municipalities following decentralization have not been precisely defined, leaving considerable grey areas. This creates an opening for constant friction and clashes. Funding is a critical aspect. Unless the decentralization of services is accompanied by mechanisms enabling the regional and municipal bodies to which they are transferred to raise or obtain the necessary resources, the process may become regressive. As Karin Stahl has said, implementing a decentralization policy without ensuring that municipalities have revenue and without equalizing the financial situation of rich and poor regions can, moreover, exacerbate regional inequalities and therefore social inequalities, further undermining the State social services system, especially in poorer municipalities.[40] Another important aspect is the institutional and managerial capacity of the bodies to which services are decentralized. If their capacities are weak, as might be expected at the outset, and no sustained effort is made to strengthen them, services will be seriously threatened. Among other things, many municipalities in developing countries lack the full-fledged career civil service that is a key to efficient management. For instance, research in Colombia, where there has been considerable decentralization, revealed that 85.5 per cent of municipalities, covering 43.5 per cent of the population, did not have the capacity to undertake the tasks assigned to them.[41] A study covering 16 Latin American countries sought to measure municipalities' management capacities by the following indicators: existence of units to take over the service, skilled human

resources, mastery of management technology, ability to develop projects, availability of financial resources, presence of a sound organizational structure and existence of a municipal career structure in the social services area. The study found that, in a range of 5 to 1 in descending order, management capacity averaged 1.[43] This kind of situation can create a vicious circle. Formally, the central Government delegates powers to municipalities, but it has misgivings about their management capacity. Instead of trying to build that capacity, it rations the practical delegation of powers, with the result that grey areas arise which seriously complicate the provision of services. The resulting difficulties then compound the Government's original misgivings.

65. Basing herself on field studies, Dagmar Raczynski warns of another problem. She writes that her analysis of Argentina and, in part, Brazil suggests that the pressures and practices of special interest groups are often far more intense at the regional, provincial and local levels than at the national level.[44] This warning may extend to broader areas. Elite power groups in regions and municipalities may seek to steer decentralized resources towards their economic or power interests. At these levels the process can be significantly distorted.

66. These and other aspects do not invalidate the promises held out by decentralization, which may be as specific as those identified by IDB in its 1996 report: there is growing evidence that results can be improved by giving schoolteachers and headteachers greater autonomy within their schools, accompanied by appropriate mechanisms for ensuring accountability. Giving parents and students greater choice and a greater say in local schools' decision-making can increase the system's ability to meet educational needs. Organizational changes can in fact be an effective catalyst for increasing accountability, improving resource allocation, stimulating innovation and generating the resources needed to enhance equity and quality.[45]

67. Seizing the opportunities offered by decentralization means explicitly identifying and confronting risks such as those mentioned. It means avoiding grey areas, creating conditions for the effective funding of services by regions and municipalities, greatly strengthening the management capacities of regions and municipalities and making sure that they are not co-opted by elite groups. Raczynski recommends that since the process is a difficult one, it is essential that it be conducted by a strong central Government which provides impetus and guidance and, at the same time, that it preserve the benefits of economies of scale and avoid increasing the already enormous inequalities that exist among the different part of any given country.[46]

D. Network-building

68. The new outlook for action in the social development field demands that all those working in this field who have a contribution to make pool their efforts. At present, there is very little coordination among social development agents and they fail to take advantage of the complementarities that joint action might offer. The State must take the lead in encouraging the building of networks that bring together public agencies in the social field, regions and municipalities, NGOs, private business foundations, trade union movements,

grass-roots religious organizations, universities, neighbourhood associations, other members of civil society and organizations representing poor communities. Such networks would be mutually supporting and draw on the best that each agent has to offer, while overcoming any weaknesses. As James Midgley has said, the respective roles of the State, the community and volunteer organizations must be taken into account and each one's strong and weak points analysed. Strategies for harmonizing the contributions of the community, the State and NGOs can also be identified."

E. Participation: a master strategy

69. The World Bank recently published The World Bank Participation Source Book, which details the new direction taken by the Bank in supporting participation." The evidence of studies conducted in this area is entirely consistent: anti-poverty and social development projects which take a participatory approach are far more successful than those based on hierarchical structures. Other international organizations are now reaching similar conclusions. IDB has just completed publication of a guide on the subject, in which it sees participation as the key to promoting development and democracy in the world." The benefits of adopting a participatory approach in the planning, management and evaluation of programmes for health, education, housing, rural development, improvement of marginal urban areas, nutrition, etc., are very tangible in management terms. Experience has shown that the involvement of the communities targeted by such programmes makes it possible to determine precisely what their priority needs are, creates a useful information flow which can be a key management tool, promotes a community input of innovative ideas, permits ongoing evaluation of the progress of the programme and is an almost infallible deterrent to potential corruption. One significant aspect is that when a community is consulted, its self-esteem is enhanced and its latent potential begins to be tapped, enabling it to make a fundamental contribution.

70. In addition to these management benefits, community participation can have a very considerable impact on an essential goal of present-day social development: programme sustainability. This is a very pressing issue. Internal evaluators have reportedly classified over half of the World Bank's projects as being of dubious sustainability, meaning that, once they are completed, a process that usually takes around five or six years, they may cease to provide significant benefits for the recipient countries." Generating medium- and long-term sustainability is a critical test of the real success of social management. As the reported evaluation indicates, without such sustainability projects fail to achieve lasting goals and are therefore inefficient. Participation is essential for building sustainability, and full community involvement will facilitate and promote the building of the community capacities that are essential for sustainability. Moreover, broad community participation makes it possible to tackle some of the strategic problems mentioned above in analysing decentralization. Decentralization to municipalities with active community involvement will help to ensure that resources really go to community priorities and prevent them from being taken over by local elites.

71. Many recent participatory experiences demonstrate the practical functioning of these clear advantages of participatory models. A broad sample of successful participatory experiences are described in the World Bank and IDB publications mentioned above and in the vast documentation on the subject produced by the United Nations system. The Grameen Bank in Asia, for instance, a popular credit bank which is 75-per-cent owned by its members and operates on a basis of broad participation, broke new ground in this field. It gave poor peasants vital access to credit and its membership grew in 10 years from 15,000 to 250,000. Villa El Salvador in Peru, a shanty town housing 250,000 poor people who started out from a situation of extreme poverty, developed a self-managing participatory approach based on 2,000 organizational units actively involving all its residents. In 20 years, they have erected 50,000 homes and an extensive network of schools and health centres, their literacy and health levels are far higher than the national average, they produce their own food and they have developed an industrial park for small businesses. The project has received a UNESCO prize, was awarded the Prince of Asturias prize by the King of Spain and has received many other international awards. In the municipal sphere, the city of Porto Alegre in Brazil has been developing a broad participatory system since 1989 to give the population a say in decisions on communal investments. In 1995, 100,000 people out of a total population of 1.3 million participated actively in the entire process. The allocation and management of resources are considered to have improved markedly as a result of this process, demonstrating the possibilities offered by decentralized municipal action combined with community participation. In all these and other similar cases, there has been a real transfer of decision-making power to the community. This sets them apart from the frequent "simulations" of participation, in which the community is promised an opportunity to participate but this is limited to statements of intent and secondary aspects, giving rise to considerable frustration.[50]

F. Improving the quality of services

72. There is general agreement that the State must drastically improve the quality of its services in general and of social services in particular. However, that line of reasoning must be carried further. What is quality in public services? Christopher Pollitt puts forward one point for consideration. Practical observation indicates that the reply to this question will vary with the actor. Perceptions of what constitutes an improvement in quality vary according to whether we are asking politicians, public administrators, professionals working in these services or users. The following is a realistic description of the situation: first, there are the politicians in power who are anxious to limit spending while assuring the public that the standard of basic public services is not being adversely affected. Next, there are the managers and senior administrators, who are obliged to follow the dictates of their political masters and rightly anxious to preserve and elevate their own institutions. They frequently clash with our third group, the professionals of the public service sector, who frequently view senior management with suspicion. Their reaction is predictable: they try to preserve their sphere of autonomy and protect their students, patients and clients. These consumers of services make up our fourth group, although it is a group that has yet to play an active role in the design of quality initiatives. Quality is something that has been done to them, rather than defined by them.[51]

73. Initiatives to improve the quality of services and introduce total quality elements should be clearly targeted to the needs of the last group, which should be allowed to give their own definition of quality. When this happens in the developing world, the beneficiaries frequently indicate priorities quite different from those established from the outside. They raise very specific issues, for example: information on programmes does not reach them, forms from public agencies to be filled out should be written in understandable language, and the respective offices should be open on days and at times compatible with their working hours.

74. Quality improvement must start with, and be carried out with, recipients if it is to result in real progress.

G. Towards an adaptive management style

75. What is the most appropriate management style for the efficient delivery of social programmes? The answer must be sought first in the requirements of the processes for implementing these programmes. Such processes are extremely volatile. When programmes targeting vast social groups, for example, programmes to extend primary health care in rural areas, lower the school drop-out rate in poor urban neighbourhoods or deliver food together with nutrition education, are implemented, highly complex and variable dynamics are created. Various interest groups, including economic interests and lobbies, gravitate around programmes and might attempt to divert them to their own ends. Different organizational agents, with variable interrelationships, are involved - ministries, regions, municipalities, NGOs and groups of civil society. Recipient communities may react in very different ways and their reaction may change over the course of the programme's execution. In the actual implementation of the programme, unforeseen opportunities and risks may arise. Frequently, decisions external to the programme and even to the entire social sector, such as budget cuts, are taken. Programme execution as a whole tends to display turbulent characteristics. Dennis Rondinelli concludes, in his analysis of the causes of the failure of various development projects support by international agencies, that irrespective of how the project was planned or how the technical analysis was conducted, rarely is the observation made that the problems encountered could not have been predicted.[52]

76. Thus, it is not a matter of adjusting earlier designs; the issue is more complicated than that. A dynamic is unleashed which in various respects cannot be predicted in advance. This dynamic cannot be controlled by applying traditional bureaucratic management styles, which use plans, routines and standards to regulate the operations to be performed. Such plans assume highly predictable situations in which projections from past situations can be an efficient guide. In the field of social management, the situation is volatile and the past is an unreliable reference because basic conditions are changing constantly. We need to move towards a style of adaptive management that is in close touch with reality and which reacts to change as it goes along. This does not mean doing away with planning, but simply changing the timing. Planning and management should be as close as possible to each other: planning, execution, feedback and redesign should be virtually one operation. Advanced management currently has different technical tools to support the management style that is

required. Among these, systems for the real-time monitoring of the progress and impact of programmes may be helpful; they involve changing from a conception of monitoring and evaluation as instruments of control to viewing them as management tools.[53]

H. Renewal of organizational structures

77. Organizational structures in the public social sector tend to follow the customary vertical, pyramidal and hierarchical models with numerous grade levels. Such models are functionally inappropriate to the requirements arising from decentralization processes, from the interest in starting up networks and promoting participation and from the need to develop adaptive management styles. Among other problems, they tend to close in on themselves, turn routines into targets, develop serious resistance to the participation of agents external to the structure, such as other possible partners and the recipient communities themselves, and can be extremely rigid in reacting to change. Progress must be made towards more open, flexible and participatory structures. The design of organizational structures is not an end in itself, but a means to facilitating the achievement of objectives. In the area of social management, the design should encourage such aspects as an active relationship with what is happening on the ground. Mintzberg advances a significant argument on this aspect.[54] We must look at organizations as circles rather than pyramids. Normally, there are those who work at the perimeter, on the edges of the circle, in active contact with recipients and with reality. They have feedback on what is happening, but because they work in very strictly defined areas, their approach is compartmentalized. In the centre of the circle we have the senior executive level, which knows where the organization is trying to go but may have little contact with reality. It tends to live in an ivory tower. In terms of social programmes, a number of suggestions can be gleaned. Such programmes must maximize the interaction with reality. A closer relationship between the perimeter and the senior executive level is essential if reality is to filter through to the latter. Likewise, an attempt must be made to apply the modern strategy of a shared vision for the organization, which can generally help to involve the perimeter fully in the operation but will also enable it to make its practical information-gathering and analysis more productive.

78. In various contexts, changes in the State social sector are taking the directions indicated. In Canada, one of the countries which have taken the lead in this area, the administration and finance division of the Ontario Ministry of Communities and Social Services announced a new organizational structure based on a trial administrative method that would reduce hierarchical levels and eliminate structural barriers. According to the division, this project would include a change in the prevailing organizational culture and values (from territorialism, a mob mentality and fear, to teamwork, trust and delegation of responsibility).[55]

I. Looking at the specifics of social management

79. What should the basic strategic orientation be for the essential institutional and managerial reforms to be undertaken in the State social

sector? The application of traditional public administration approaches has revealed serious shortcomings and conflicts with the demands of reality. However, there also does not seem to be any empirical evidence to support the use of business-style approaches in this field, since their goals and usual characteristics differ markedly from the objectives and typical functioning of social programmes. Social programmes have development targets whose effects are often seen basically in the medium and long term, as happens in education. Their targets interact with those of other programmes. In some cases, their goals cannot be measured by the means normally used in business management because they are qualitative. Moreover, in the social programmes of the developing world there are overall goals under which the specific goals of a programme in a given area are subsumed. It is hoped that all programmes will help to enhance equity, overcome gender discrimination, promote environmental preservation and achieve sustainable development. The technical operation of implementing social programmes is also very different from that of business organizations. As we have seen, it is characterized by multiple institutional actors, the need to coordinate them, networks, turbulence, the essential need for participation because of its wide-ranging positive effects, the need to respect local cultures, and the impact of political, social, demographic and other factors. The list of management dilemmas that arise in operations of this kind is unique and quite different from that arising in business.

80. An approach must be developed in this field that focuses on the specific problems of social institutions and social management and seeks appropriate technical solutions to them. A social management approach is required. Its inputs of support would include elements of other approaches, but the strategic approach must be different and be efficient in terms of goals and overall goals, such as those listed and of the particular type of technical operation that characterizes social programmes and policies. This approach is emerging in specific experiences of successful institutional adjustments and programmes in different countries. The type of institutions and management discerned in what are internationally viewed as examples of managerial excellence, such as the Grameen Bank in Asia, the EDUCO schools in El Salvador or the neighbourhood consumer fairs in Venezuela, arise out of this differentiated approach.[56] The observation of this technical dimension of social management is currently stimulating efforts to train social managers in this area in various countries of the developing world.[57]

81. The need to respect specific characteristics and not to transfer the business approach mechanically to other fields is not exclusive to the social sector. Paul Krugman warns of the danger of such transfers to the economic field in a recent article, "A country is not a company".[58] He calls attention to what he considers a dangerous tendency to seek to apply a business approach to countries. He says that what people learn from running a business does not help them to formulate economic policy. A country is not a major corporation. The mental processes that make a great business leader are not generally those that make a great economic analyst. He notes that the problems are of a totally

difficulty accepting that they must go back to school before they can make pronouncements in a new field.

82. Just as the macroeconomic sphere demands macroeconomic management, the goals and functioning of social management cannot be equated with business logic. Much more needs to be done to ensure such essential aspects as access, equity, sustainability and efficiency.

V. FINAL NOTE

83. According to Goethe, theories are grey, while the golden tree of life is green. In the developing world of recent decades, a number of theoretical models have indeed succumbed to or been seriously challenged by reality. Approaches based on a mechanistic vision, which puts off solving today's acute social problems to an imaginary future where there will allegedly have been a "trickle-down" of growth, have not been validated by the facts. Instead, they have resulted in a systematic marginalization of social policy and management which has aggravated social problems. Combined with a misperception of inequity as being conducive to growth, a perception totally negated by the case of South-East Asia and other societies and by the marginalization of human and social capital, these approaches have caused the social sphere to be largely abandoned, with many far-reaching consequences. At the macroeconomic level, ignoring the social dimension creates major obstacles to opportunities for sustained growth. Neglect of education, health and nutrition, weakening of the family and increasing personal insecurity are processes which undermine growth, deter investment and impede technological progress and the development of external competitiveness. The case of Latin America is also illustrative of other parts of the developing world. Nancy Birdsall pinpoints the economic significance of such obstacles in the region when she says that it is possible that growth rates in Latin America simply cannot go above 3 or 4 per cent as long as the half of the population which is in the lowest income percentiles is unable to participate and make a contribution.[58] To this observation we might add another, from the World Bank, concerning the high level of unemployment in the region: for Latin America to be able to lower its unemployment rates in the coming years, the region's gross domestic product will have to grow by more than 4 per cent.[59] What we have here is a vicious circle. Reducing the region's critical unemployment level of over 16 per cent will require a growth rate of over 4 per cent, and such growth will happen only if the vast sectors of the population currently below the poverty line are brought into the development process.

84. A deteriorating social situation also has high costs in terms of democratic governance. A broad survey of public opinion in 17 Latin American countries showed that, while the great majority of the population are in favour of the democratic system, only 27 per cent of those surveyed are satisfied with the

85. The assertion of a contradiction between State and market and the consequent calls for a minimalist State are also being seriously challenged by the facts on the ground.

86. The new debate is therefore suggesting that the best results in recent years have been achieved with a broad combination of State, plus market, plus civil society in all its manifestation. An absent or minimal State does not seem to be the answer to social problems or, more generally, to the need to encourage sustained development. The idea of an intelligent, highly efficient State which intervenes at strategic moments is steadily gaining ground. Merilee Grindle says that it has been noted that only States can provide the set of conditions essential to economic development: law, order, effective macroeconomic policies, infrastructure development, investment in human capital and greater equity.[61]

87. One essential field of activity of the intelligent State in the developing world in coming decades will be the vigorous, sustained promotion of active integration of economic and social development, together with a substantial improvement in equity. The State will also have to promote the active involvement of all the basic forces of society in those efforts. To achieve all this, it will have to take on the task of forging strategic alliances among those forces.

88. Performing these new roles efficiently will require radically reforming the State's social structures. Such a reform must not be backward-looking, but neither should it mean simply cutting back on or dismantling those structures. Institutional imagination will be required for rethinking the State in the social field. It is therefore essential to set aside conventional wisdom and the numerous dogmas of theoretical models with no answers that stand in the way of progress towards innovative solutions. This collective task cannot be delayed, for the social opportunity cost is very high. Every moment that passes without sustained policies of education and health investment, without efforts to increase equity and without efficient, high-quality public social services has a drastic regressive impact on the basic living conditions of vast numbers of long-suffering people in the developing world and prolongs their unjustifiable social exclusion.

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